

Analyzing the Sources and Impact of Segmentation in the Banking Sector: A Case Study of Kenya

Radha Upadhyaya

Thesis submitted for the degree PhD in Economics

2011

**Department of Economics
School of Oriental and African Studies (SOAS)
University of London**

Declaration:

I have read and understood regulation 17.9 of the Regulations for students of the School of Oriental and African Studies concerning plagiarism. I undertake that all the material presented for examination is my own work and has not been written for me, in whole or in part by any other person. I also undertake that any quotation or paraphrase from the published or unpublished work of another person has been duly acknowledged in the work which I present for examination.

Radha Upadhyaya

Signed: _____

Date: _____

Abstract

The banking systems in sub-Saharan Africa (SSA) in general and Kenya in particular, are shallow and fragile. This is reflected in low lending levels, high interest rate spreads, high levels of non-performing loans and several bank failures. This thesis aims to understand the sources of this shallowness and fragility in Kenya and begins with the acknowledgement that the banking system in Kenya is highly segmented by size and ownership factors. The four segments identified are foreign owned banks, government owned banks, large private owned banks and small private owned banks. Within the framework of segmentation, this thesis analyzes three different relationships: between a bank and its borrowers (lending relationship), between a bank and its depositors (deposit mobilization), and between the shareholders and management of a bank (corporate governance).

The analysis shows that different segments of the banking sector face clients of significantly different size and type, and that this segmentation has a strong impact on performance of banks in each of the segments. The analysis shows that segmentation is based partly on economic factors such as the size of banks and structure of ownership, but largely on social factors that determine the trust between banks and their clients. The thesis demonstrates that due to segmentation, there are varying 'radiuses of trust' within one banking system and that segmentation is a result of fragmentation rather than specialization. The thesis argues that segmentation affects lending decisions, deposit mobilization and governance of banks and therefore the structural constraints faced by banks in Kenya are varied, complex and grounded in social factors. The analysis shows that segmentation is both a cause and consequence of the shallowness and fragility of the banking sector.

Acknowledgements

The process of writing this doctoral thesis has been a long journey and I have incurred many debts on the way. I would like to thank my supervisor Prof. Machiko Nissanke for her guidance and support. I would also like to thank her for being truly heterodox and pluralist in her approach and I hope this is reflected in this work. A special thanks to my research tutor Prof. Ben Fine for inspiration and encouragement and Dr. Jan Toporowski for extremely interesting discussions.

Myriam Blin-Malleck has become a dear friend. But before that, her research methods course opened my eyes and inspired many aspects of the research design of this thesis.

I am extremely grateful to the Central Research Fund of the University of London and the School of Oriental and African Studies for fieldwork grants. I would also like to thank Sedat Aybar, Paolo dos Santos and Kobil Ruziev for sharing their PhD thesis with me - each one has guided me enormously.

I would like to thank all the staff of the Central Bank of Kenya Supervision Department who helped me during my data collection. A special thank you to Kelevilin Kimathi who went way beyond the call of duty to help me. I would like to thank all the bankers who agreed to be interviewed. A big thanks to Ochieng Oloo of Market Intelligence Magazine for sharing his dataset on Kenyan banks so openly. I would also like to thank David Ndi for his extremely useful comments on my research design and also sharing his knowledge on the history of the banking sector in Kenya. A special thanks to my friend Shanif Dewany for helping to arrange many of the interviews and also for his insightful comments on the banking sector in Kenya.

I have made many wonderful new friends at SOAS: Abhishek Amar, Amaia Sánchez, Annina Kaltenbrunner, Aurora Tellenbach, Chirashree das Gupta, Damian Tobin, Elisa Van Waeyenberge, Elsbeth Court, Elva Bova, Emma Flatt, Foqia Khan, Gill Rogers, Giovanni Cozzi, George Kunnath, Hannah Bargawi, Hazel Gray, Helen Tilley, Joachim Kolb, Julia Gallagher, Jyoti Saraswati, Katia Fabbri, Majak D'Agoot, Marie Gibert, Monica Unda, Nicoletta Demetriou, Reut Barak, Sahar Rad, Sandra Fahy, Shweta Sachdeva, Susan Newman and Takahiro Fukunishi. Each of them have inspired me intellectually but also made this journey extremely enjoyable and rewarding. A special thank you to Lotta Takala-Greenish. I immensely enjoyed working together in the

library and found her guidance on pregnancy and baby related issues invaluable. I would also like to thank Meenakshi Varia and Francesca Campagnoli for their friendship and encouragement.

While writing this thesis I was also managing our family business in Nairobi, through email and frequent visits. I would like to thank all our staff for their hard work. In particular, I am grateful to our managing agent Alfred Mugwe and office administrator Gregory Valai. Their efficiency and dedication gave me a lot of peace of mind.

I am also grateful to Bhoomi Pathak who has been an extremely warm and loving childminder for my baby in the last few months.

I am greatly indebted to my friend Diana Jackson for helping me to stick to deadlines during the final stages, for editing the entire thesis and her extremely insightful comments.

Last but not least I would like to thank my family for sustaining me during this long process. My grandparents for passing on their 'fighting spirit'. My mother who always reminded me to 'keep smiling' and for never complaining about living alone in Nairobi, my in laws who have always treated me like a real daughter and my brother and sister in law Divyesh and Hena for encouragement. I would also like to thank my uncle Ravi who first sparked my interest in development economics and also for help with editing this thesis and my sister Seeta for being my best friend and also for her indefatigable faith in me. And my husband - I fell in love with him on a mountaineering expedition many years ago because he was reliable, extremely calm when I got our whole group lost overnight and had an amazing sense of humor. These qualities have been invaluable in helping me climb the 'PhD mountain.' Rajal thank you for being with me every step of the way. And finally, my little baby son Batian whose smiles and laughter light up every day.

I would like to dedicate this thesis to my late father Jayant J. Ruparel who is missed deeply. He had a never-ending thirst for learning and imbued the same passion in me.

Table of Contents

PROLOGUE.....	16
CHAPTER 1 – MOTIVATION, CONTEXT AND STRUCTURE.....	18
1.1 Introduction.....	18
1.2 Background of the Study – The Performance of Banking Systems in SSA	19
1.3 Conceptual Framework – Segmentation and Relationships in Banking	23
1.4 Research Questions	25
1.4.1 <i>Lending Relationship</i>	26
1.4.2 <i>Deposit Mobilization</i>	27
1.4.3 <i>Corporate Governance</i>	27
1.5 Methodology, Methods, Data Collection and Data Analysis.....	28
1.5.1 <i>Ontology and Methodology</i>	28
1.5.2 <i>Strengths of Qualitative and Quantitative Data</i>	31
1.5.3 <i>Summary of Data Collected</i>	33
1.5.4 <i>Limitations of Data Collected</i>	33
1.5.5 <i>Data Analysis</i>	35
1.6 Structure and Contributions of the Thesis	36
CHAPTER 2 – FINANCE AND DEVELOPMENT.....	39
2.1 Introduction.....	39
2.2 Debates in Finance and Development I – Finance and Growth	39
2.3 Debates in Finance and Development II – Financial System Design.....	45
2.4 Bank Failures and Fragility – Theoretical and Empirical Studies.....	50
2.5 Concluding Remarks	53
CHAPTER 3 – STUDIES ON FINANCE IN AFRICA.....	55
3.1 Introduction.....	55
3.2 Studies on the Link between Finance and Growth in Africa.....	56
3.3 Studies on the Impact of Financial Liberalization in Africa.....	60
3.4 Studies on Market Structure and Competition in Banks in Africa.....	63
3.5 Studies on the Efficiency of Banks in Africa.....	69
3.6 Studies on the Excess Liquidity of Banks in Africa	77
3.7 Studies on Bank Failures in Africa	80
3.8 Studies on the Ability of Banks to Mobilize Deposits in Africa	82
3.9 Concluding Remarks	83

CHAPTER 4 – THE KENYAN BANKING SECTOR.....	85
4.1 Introduction.....	85
4.2 Historical Overview of the Development of Banking in Kenya.....	85
4.2.1 <i>Banking in Colonial Kenya – Origins 1896 to 1950</i>	<i>85</i>
4.2.2 <i>Pre-Independence Growth – 1950 - 1963.....</i>	<i>87</i>
4.2.3 <i>Harambee - Creation of Government Owned Banks – 1963 - 1980.....</i>	<i>90</i>
4.2.4 <i>Nyayo – The Rise of Indigenous and Political Banks – 1980 - 1990.....</i>	<i>93</i>
4.2.5 <i>Early Liberalization 1990 - 1994.....</i>	<i>96</i>
4.2.6 <i>Consolidation and Changes in Regulation 1994 - 2005.....</i>	<i>98</i>
4.3 Trends in Key Banking Indicators 1990 - 2005	101
4.3.1 <i>Financial Deepening Ratios</i>	<i>101</i>
4.3.2 <i>Loan to Deposit Ratio.....</i>	<i>103</i>
4.3.3 <i>Interest Rate Spreads</i>	<i>104</i>
4.3.4 <i>Non Performing Loans</i>	<i>105</i>
4.3.5 <i>Bank Failures</i>	<i>106</i>
4.4 Studies of the Banking Sector in Kenya.....	110
4.4.1 <i>Studies on the Link between Finance and Growth in Kenya.....</i>	<i>110</i>
4.4.2 <i>Studies on the Impact of Financial Liberalization in Kenya.....</i>	<i>112</i>
4.4.3 <i>Studies on the Market Structure and Competition in Banks in Kenya.....</i>	<i>113</i>
4.4.4 <i>Studies on Interest Rate Spreads in Kenya.....</i>	<i>114</i>
4.4.5 <i>Studies on Non-Performing Loans in Kenya.....</i>	<i>116</i>
4.4.6 <i>Studies on Bank Failures in Kenya.....</i>	<i>117</i>
4.4.7 <i>Studies on Ability of Banks to Mobilize Deposits in Kenya</i>	<i>120</i>
4.4.8 <i>Studies Considering the Segmentation of the Banking Sector</i>	<i>121</i>
4.5 A Deeper Look at Segmentation.....	124
4.5.1 <i>Structure of the Banking Sector 2005</i>	<i>125</i>
4.5.2 <i>Financial Data by Segments 2000 - 2005.....</i>	<i>129</i>
4.5.3 <i>Foreign Owned Banks (FOB) Segment.....</i>	<i>130</i>
4.5.4 <i>Government Owned Banks (GOB) Segment</i>	<i>132</i>
4.5.5 <i>Large Private Owned Banks (LPOB) Segment.....</i>	<i>132</i>
4.5.6 <i>Small Private Owned Banks (SPOB) Segment</i>	<i>133</i>
4.5.7 <i>Race Relations and Ethnicity in Kenya</i>	<i>134</i>
4.6 Concluding Remarks	136

**CHAPTER 5 – THEORETICAL CONCEPTS ON LENDING AND DEPOSIT
MOBILIZATION RELATIONSHIPS 138**

5.1	Introduction.....	138
5.2	The Lending Relationship - Information Asymmetry and Transaction Costs.....	139
5.3	The Lending Relationship - Knowledge Creation.....	140
5.4	The Lending Relationship – Social Factors and Trust.....	142
5.5	The Deposit Mobilization Relationship	149
5.6	Concluding Remarks	153

**CHAPTER 6 – BANK LENDING AND DEPOSIT MOBILIZATION: THE
EXPERIENCE OF THE BANKING SECTOR IN KENYA..... 154**

6.1	Introduction.....	154
6.2	Constraints to Lending - Summary.....	155
6.3	Constraints to Lending - Economic and Legal Environment	158
6.3.1	<i>Conditions in the Real Economy and Changes in the Economic Environment.....</i>	<i>158</i>
6.3.2	<i>Impact of Poor Legal System and Unreliability of Collateral.....</i>	<i>160</i>
6.4	Constraints to Lending – Fluid Social Factors and Inadequacies in Information Production and Monitoring	164
6.4.1	<i>Information Production by FOB – The Benchmark</i>	<i>165</i>
6.4.2	<i>Lack of Credit Registry and References from Other Banks</i>	<i>167</i>
6.4.3	<i>Over-reliance on Security Based (Collateral) Lending.....</i>	<i>169</i>
6.4.4	<i>Overreliance on ‘Name Lending’ and Change in Social Factors.....</i>	<i>169</i>
6.4.5	<i>Unreliability of Financial Accounts (‘Hard’ Information).....</i>	<i>172</i>
6.4.6	<i>Lapses in Internal Control.....</i>	<i>174</i>
6.4.7	<i>Constrained by Image as Ethnic Bank.....</i>	<i>175</i>
6.4.8	<i>The Need to Educate Clients</i>	<i>175</i>
6.4.9	<i>Regulation on Lending.....</i>	<i>176</i>
6.5	Deposit Mobilization.....	177
6.6	Concluding Remarks	186

**CHAPTER 7 – THEORETICAL CONCEPTS ON CORPORATE
GOVERNANCE RELATIONSHIPS 190**

7.1	Introduction.....	190
7.2	Corporate Governance: Concepts and Issues	191
7.3	Ownership Structure and Corporate Governance.....	193
7.4	Board Structure and Corporate Governance.....	198
7.4.1	<i>Board Size.....</i>	<i>198</i>

7.4.2	<i>Board Independence</i>	199
7.4.3	<i>CEO / Chairman Duality</i>	201
7.4.4	<i>Committee Structure of Boards</i>	202
7.5	Corporate Governance in Africa.....	203
7.6	Corporate Governance of Banks with Focus on Insider Lending.....	211
7.7	Concluding Remarks	215

CHAPTER 8 – CORPORATE GOVERNANCE: THE EXPERIENCE OF THE BANKING SECTOR IN KENYA..... 217

8.1	Introduction.....	217
8.2	Ownership and Management Structure of Banks in Kenya.....	217
8.3	Regulation of Corporate Governance of Banks in Kenya	221
8.3.1	<i>OECD and Basel Principles</i>	221
8.3.2	<i>Central Bank of Kenya Guidelines</i>	224
8.4	Compliance with Central Bank of Kenya Guidelines	227
8.4.1	<i>Separation of Ownership and Management</i>	228
8.4.2	<i>Responsibility of Board of Directors</i>	231
8.4.3	<i>Independence of Board of Directors</i>	234
8.4.4	<i>CEO Duality and Committee Structures</i>	235
8.4.5	<i>Vetting of Directors</i>	237
8.4.6	<i>Disclosure and Transparency</i>	238
8.4.7	<i>Insider Lending</i>	240
8.5	Corporate Governance Areas without CBK Guidelines	241
8.5.1	<i>Overall Corporate Governance Framework</i>	241
8.5.2	<i>Rights of Shareholders and Stakeholders</i>	241
8.5.3	<i>Legal Protection for Minority Shareholders in Kenya</i>	242
8.5.4	<i>Corporate Control of Banks</i>	244
8.6	Concluding Remarks	245

CHAPTER 9 – CONCLUSIONS AND IMPLICATIONS FOR RESEARCH AND POLICY..... 247

9.1	Introduction.....	247
9.2	Research Summary.....	247
9.2.1	<i>Background, History and Segmentation</i>	247
9.2.2	<i>Lending and Deposit Mobilization</i>	250
9.2.3	<i>Corporate Governance</i>	251

9.3	Developments in the Banking Sector Post Fieldwork	253
9.3.1	<i>Performance of the Banking Sector</i>	253
9.3.2	<i>Industry Structure</i>	254
9.3.3	<i>Innovations</i>	257
9.4	Issues for Research and Policy Directions.....	258
BIBLIOGRAPHY		261

List of Tables

Table 1: Regional Comparison of Banking System Indicators 2004.....	19
Table 2: Structural Features of Banking Systems in SSA	64
Table 3: Interpretation of H Value	65
Table 4: H Statistic for Different Countries / Regions.....	66
Table 5: Summary of H Statistic for Zambia from Musonda (2008)	67
Table 6: Bank and Ownership Efficiency Change Measures in Uganda 1993 – 2005	71
Table 7: Regression Results of the Determinants of Productivity in Uganda	72
Table 8: Bank and ownership efficiency change measures in Tanzania 1998 – 2005.....	73
Table 9: Regression Results of the Determinants of Bank (In)efficiency in Tanzania....	74
Table 10: Causes of Excess Liquidity in Tanzania 1999 – 2004	78
Table 11: Monetization, Assets and Deposits held by Banks in East Africa 1950 – 1963	88
Table 12: Banks Operating in Kenya in 1963	89
Table 13: Number of Financial Institutions in Kenya.....	97
Table 14 : Regulatory Minimum Capital Requirements for Banks in Kenya.....	99
Table 15: Regulatory Capital Ratios of Banks in Kenya.....	100
Table 16: Trends in Loans, Non-performing Loans and Provisions for Banks and NBFI's in Kenya (KShs billion) 1994 – 2005.....	105
Table 17: Failure of Banks and NBFI's in Kenya 1984 – 2005	107
Table 18: Decomposition of Interest Rate Spreads in Kenya (%) 2002.....	122
Table 19 : Summary Structure of Banking Industry in 2005	125
Table 20: Change in Share of Assets by Segments 2000 - 2005.....	129
Table 21: Financial Performance and Portfolio Characteristics of Segments (Average 2000-2005).....	130
Table 22: Constraints to Lending and Reasons for High NPLs	157
Table 23: Information Collected by FOB - Benchmark	165
Table 24 : Comparison between Anglo-American and Eurasian Corporate Governance Models.....	192
Table 25 : Theoretical Links between Ownership Structure, Governance Mechanisms and Weaknesses in Mechanisms	197
Table 26 : Average Board Size and Separation of CEO / Chairperson Role in SSA....	203
Table 27 : Impact of Corporate Governance Measure on Firm Performance in Nigeria from 1996 - 1999.....	205

Table 28 : Impact of Board Independence on Firm Performance in Nigeria from 1996 – 2004	207
Table 29: Effect of Corporate Governance on Shareholder Value in Four African Countries 1997 - 2001	210
Table 30 : Ownership Structure of Bank in Kenya 2005 including Details on Ownership Concentration	219
Table 31: Corporate Governance Requirements by the CBK 2006.....	225
Table 32: Corporate Governance Characteristics and Constraints in Complying with Regulations by Segments.....	227
Table 33: The Structure of Boards of Banks in Kenya	232
Table 34: Insider Lending in Kenyan Banks 2000 - 2005	240
Table 35: Kenyan Banking System Indicators 2004 and 2008	253

List of Figures

Figure 1: Framework of Analysis – Segments and Relationships in Banking Sector in Kenya	25
Figure 2: Cross Country Evidence on the Links between Financial Development and Growth.....	40
Figure 3: Theoretical Links between Finance and Growth	42
Figure 4: Simplified Balance Sheet of a Bank	50
Figure 5 : Financial Deepening Ratios 1990 – 2005	101
Figure 6: Loan to Deposit Ratio from 1990 - 2005	103
Figure 7: Trend in Interest Rate Spread (%) in Kenya 1991 – 2005	104
Figure 8 : Non-performing Loans as a proportion of Total Loans (%) 1994 – 2005 ...	106
Figure 9: Market Share by Segment (2005)	129
Figure 10: Growth of Deposits of Bank of Baroda	182

List of Appendices

Appendix 1: Major Bank Insolvencies in Africa 1980-2000.....	279
Appendix 2: Summary and Full List of Semi-Structured Interview Questions.....	282
Appendix 3: Variables in Financial Statements Database for Kenyan Banks.....	285
Appendix 4: Variables in Corporate Governance Database for Kenyan Banks	287
Appendix 5: Summary of Stages of Banking Development	288
Appendix 6: Plea for Pluralistic and Rigorous Economics.....	289
Appendix 7: Kenya GDP Growth, Inflation, Exchange Rates and T-Bill Rates (1990- 2005).....	290
Appendix 8: Methodology of Decomposition of Interest Rate Spreads used in Beck and Fuchs (2004).....	291
Appendix 9: Return on Assets by Segment 2000 - 2005.....	292
Appendix 10: Core Capital on Total Risk Weighted Assets by Segment 2000 - 2005 ..	292
Appendix 11: Loans on Total Assets by Segment 2000 - 2005.....	292
Appendix 12: Government Securities on Total Loans by Segment 2000 - 2005	292
Appendix 13: Total Loans on Total Deposits by Segment 2000 - 2005.....	293
Appendix 14: Non-Performing Loans by Segment 2000 - 2005	293
Appendix 15: Cost of Funds by Segment 2000 - 2005.....	293
Appendix 16: Number of Branches per Bank 2005	294
Appendix 17: Average Number of Branches per Segment 2005.....	295
Appendix 18: Old Credit Analysis, Bank 6, SPOB (up to 2004)	296
Appendix 19: New Credit Analysis, Bank 6, SPOB (From 2004)	301
Appendix 20: Control of Publicly Traded Firms Around the World, 1996 (%) (of the 20 largest firms under each Category)	316
Appendix 21: Duties of Directors in the 2006 CBK Guidelines	317

List of Acronyms and Abbreviations

AGM	Annual General Meeting
bn	Billion
BOZ	Bank of Zambia
CAMEL	Capital, Asset, Earnings, Management, Earnings, Liquidity
CBK	Central Bank of Kenya
CEO	Chief Executive Officer
CMA	Capital Markets Authority
DEA	Development Envelope Analysis
DPFB	Deposit Protection Fund Board
FOB	Foreign Owned Bank(s)
GOB	Government Owned Bank(s)
GoK	Government of Kenya
IPO	Initial Public Offering
KCB	Kenya Commercial Bank
KShs.	Kenya Shillings
LPOB	local Large Private Owned Bank(s)
m	Million
MENA	Middle East and North Africa
NBFI	Non-Bank Financial Institution(s)
NBK	National Bank of Kenya
NPL	Non Performing Loans
NSE	Nairobi Stock Exchange
OECD	Organization for Economic Co-operation and Development
PE	Price - Equity (ratio)
ROA	Return on Assets
ROE	Return on Equity
S-C-P	Structure-Conduct-Performance
SME	Small and Medium sized enterprise
SPOB	local Small Private Owned Bank(s)
SSA	Sub-Saharan Africa
T Bill	Treasury Bill
USD	United States Dollar

PROLOGUE

In September 1998, I was back in Nairobi after completing my undergraduate degree in Economics at Cambridge and my Masters at SOAS. I was working as a research assistant at the African Economic Research Consortium, carrying out lots of cross-country regression analysis of just the type I have eventually come to criticize in this thesis.

During this time five Asian-African banks were put under statutory management by the Central Bank of Kenya: including Trust Bank which was the 6th largest bank by deposits at the time. One of these banks was Bullion Bank. Unfortunately when Bullion Bank closed my family's deposits with the bank represented all our savings. The Central Bank Governor at the time – Micah Cheseram, did something very unusual: he appointed Depositors' Committees to assist the Central Bank statutory managers revive the bank. Maybe it was due to pressure from the World Bank, or perhaps reflected a recognition that previous episodes of statutory management had barely returned 10% of deposits back to depositors and a genuine desire to do better for the depositors of these recently failed banks.

These committees had no real legal mandate. As a depositor, my father was on the Depositors' Committee for Bullion Bank. He set about it with zeal and ended up uncovering a fraud committed by the CBK statutory manager at Bullion Bank in cahoots with the previous shareholders after it had been taken over by the CBK. Unfortunately, due to the undiplomatic manner in which he passed on this information, the Governor asked for his resignation from the Depositors' Committee. But, unexpectedly, the Governor said that I could be on the committee as my father's representative.

I stopped being an economist and became a debt collector, financial analyst, and negotiator with lawyers and accountants. I became the Secretary of the Committee and as a result got a very unique insight into the progress of the Committee's work. Bullion Bank was reopened in 2000 on a debt-equity swap where depositors converted 45% of their deposits to equity, and I became a Director of the bank. As a board member, I helped to negotiate the merger with Southern Credit Banking Corporation which ensured that depositors finally got paid the remaining 55% of their deposits.

In 2003, when I decided that I wanted to go back to being an economist, I realised that there was relatively little written about commercial banking in Sub Saharan Africa, and Kenya in particular, and therefore decided to focus my thesis on this area. As social scientists we always have to question whether we are ‘too close to the subject to be objective’. But on the other hand that personal connection allows us to identify pressing problems that economics can help to solve: and isn’t that what economists are supposed to try to do – understand real world problems that affect real people?

While I was working at Bullion Bank I also worked for my family business, an estate agency. We managed several properties and collected rent on behalf of landlords. I had the extremely emotional, and sometimes surreal, experience of having clients leaving their gold bangles with me in lieu of rent. They had lost their life savings in Trust Bank. So yes, the reasons for embarking on this line of research were very personal – but as a result I believe that the insights and conclusions that spring from this work have a wider application to the functioning of credit markets throughout Sub Saharan Africa and further afield.

CHAPTER 1 – MOTIVATION, CONTEXT AND STRUCTURE

1.1 Introduction

It has been recognized that financial systems in Africa in general and Kenya specifically, are both shallow and fragile and therefore cannot fulfil the real economy objectives of growth and poverty eradication (Mkandawire, 1999, Stein et al., 2002, Serieux, 2008 Ffrench-Davis 1994; Mkandawire 1999; Nissanke & Stein 2003).¹ The shallowness and fragility is reflected in low lending levels, high interest rate spreads, high levels of non-performing loans and several bank failures.

The main aim of this thesis is to provide a deep understanding of the working of the banking system in Kenya and the constraints faced by banks that explain the reasons for the poor performance of the banking system. The key contribution of this thesis is to show that a major factor in this poor performance is that the banking system in Kenya is segmented and that this segmentation is based mainly on social factors. Social factors determine the trust levels between banks and their borrowers and depositors and in turn affect the performance of banks. Segmentation also implies that regulation aimed at changing corporate governance of banks may not have the desired impact in terms of improving bank performance.

In Section 1.2 this chapter discusses the background and context of this study by presenting data on the shallowness and fragility of the banking sectors in SSA and Kenya. In Section 1.3 the framework of analysis of this research is discussed. In particular we define the segments of the banking sector in Kenya that we are investigating – foreign owned banks, government owned banks, large private owned banks and small private owned banks. We also define the three main relationships in banking that we are analyzing - lending, deposit mobilization and corporate governance. Section 1.4 discusses the main research questions of this thesis. The methodological basis and methods used in the research are discussed in Section 1.5. The chapter concludes with Section 1.6 in which contributions and structure of the thesis is outlined.

¹ There remain several debates in the literature on the links between finance and growth. These are discussed in Chapter 2. However, there is consensus that finance fulfils certain functions that are necessary for growth.

1.2 Background of the Study – The Performance of Banking Systems in SSA

In general African financial markets are shallow compared to financial markets in emerging and high-income countries.² A regional comparison of selected banking system indicators is displayed in Table 1.

Table 1: Regional Comparison of Banking System Indicators 2004

	Kenya	Ug.	Tz.	Ghana	SSA Average	Low Income	East Asia	High Income
Depth Indicators								
Liquid Liabilities to GDP	40%	19%	22%	29%	31%	29%	49%	100%
Deposits to GDP	33%	15%	17%	20%	24%	22%	42%	85%
Private Sector Credit to GDP	25%	6%	8%	12%	18%	15%	35%	107%
Efficiency Indicators								
Loan on Deposit Ratio	73%	40%	47%	59%	66%	66%	81%	100%
Net Interest Margin	7%	13%	8%	10%	8%	8%	3%	2%
Interest rate spread	13%	14%	13%		12%			4%
NPLs on Total Loans	41%	7%	12%	29%	-	-	-	-

Source: -

- 1) All data except data on non-performing loans is from Financial Structure Database, as described in Beck, Demirgüç-Kunt, & Levine (2000 - revised 2009), hereafter referred to as World Bank Financial Structure Database (2000 revised 2009). It is for the year 2004.
- 2) Data on spreads is from Beck & Fuchs (2004) and is for the year 2001.
- 3) Data on Non-performing loans is from Buchs & Mathisen (2005) and is for the year 2001.

² Data for this section is from Financial Structure Database, as described in Beck, Demirgüç-Kunt, & Levine (2000 - revised 2009) and available through the World Bank web page on <http://go.worldbank.org/X23UD9QUX0>. This dataset combines data from the IMF's International Financial Statistics and Fitch's BankScope Database.

There are two main measures of depth of the financial system - ratio of liquid liabilities to GDP and ratio of private credit to GDP.³ The former is a measure of monetary resources mobilized by banks. The latter is a measure of the ability of banks to channel resources to productive uses and therefore the growth potential of financial intermediation.⁴ At a bank specific level, the measures refer to the liability (deposit mobilization) and asset (lending) side of individual banks balance sheets.⁵ In 2004, the ratio of liquid liabilities to GDP averages 31% in SSA, compared to 49% in East Asia & Pacific and 100% in high-income countries.⁶ In 2004, the ratio of private credit to GDP averages 18% in SSA compared to 35% in East Asia and 107% in high-income countries.

Interest rate spread and interest rate margins are the most common measure of bank inefficiency and therefore an explanation for the shallowness of banking systems. The spread is often thought of as a 'premium in the cost of external funds' introduced due to informational and enforcement frictions (Gertler & Rose, 1994; Honohan & Beck, 2007). Interest rate spread is measured as the difference between the average lending rate and the average deposit rate. Interest rate margins are measured as net interest income as a percentage of total earning assets. Interest rate margins and spreads in SSA are generally higher than the rest of the world. In 2004, the net interest margin for African banks was 8% compared to 3% for East Asia and 2.2% for high-income countries. It should be noted that this is the mainstream definition of spread. We would

³ As will be seen below in Chapters 3 and 4, historically monetary aggregates have been used to measure financial depth. M2 (broad money) is normally defined as M1 plus time and savings deposits plus certificates of deposits plus deposits of NBFIs. M1 is defined as currency outside the banking system plus demand deposits. There are also other definitions of broad money that differ from country to country. M3 normally includes deposits of non-bank financial institutions (Black, 2002). However liquid liabilities over GDP has become the preferred definition to M2 over GDP as the former excludes currency outside the banking or financial system.

⁴ As will be shown in Chapters 2 and 3, there was an assumption in the finance and growth literature that an increase in deposits, reflected in an increase in M2, would 'automatically' lead to an increase in lending. This has not been the experience of developing countries post liberalization.

⁵ In developed financial markets a bank's balance sheet will include a variety of instruments on both the liability and asset side. However in a developing country a bank's balance sheet is relatively simple with the main liability consisting of deposits and the main assets consisting of loans and investment in government securities.

⁶ Deposits form the core of liquid liabilities in developing countries and the deposit to GDP ratio of SSA is also low compared to East Asia or high-income countries.

like to argue that that while a high overall spread shows weakness in a banking system an analysis of different segments in a banking system shows that the source for high spread is not necessarily inefficiency but based on trust and social factors. This is discussed in detail in Chapter 6.

The main cost of shallowness of the banking sector is low access to finance and low levels of investment in SSA. Despite changes in policy stance from high levels of government intervention in the financial systems in SSA between the 1960s to 1980s, to more liberalized financial systems from the 1990s, savings and investment levels in SSA remain extremely low (Mavrotas, 2005; Serieux, 2008 pp., 5; A Soyibo, 1997).⁷

Furthermore, the banking systems in SSA are fragile and unstable. It should be noted that instability is difficult to define and it usually measured as the lack of stability – therefore in terms of bank failures. Appendix 1 lists bank failures in SSA from 1997 – 2005. The list is extremely general, but highlights the frequency of bank failures throughout SSA and also the high levels of non-performing loans accrued in the banks prior to the bank failures.

Theoretically the cost of bank failures can be categorized as: -

- Financial distress and loss experienced by depositors. It has been argued that bank failures may result in loss of deposits that represent depositors' life savings and therefore bank failures arguably impose significantly more costs than the insolvency of a normal firm (Mayes, 2004).
- Loss of information and reputational capital experienced by borrowers who have to find other sources of credit to continue their business (Bernanke, 1983; Bernanke & Gertler, 1987).
- Disruption of the payment system.
- Systemic risk of contagion effects leading to closure of other banks (Guttentag & Herring, 1987).

⁷ The average figure for total domestic savings to GDP for 19 African countries stood at about 11 % in 1965. It peaked at 14 per cent of GDP in 1974 and declined to a nadir of just over seven per cent in 1982. It recovered modestly to around 11 % and then stagnated at around 10 per cent through the 1990s, showing signs of a renewed rise only after 1999. Total investment followed a similar pattern starting at around 13%, peaking at 20% in the 1970s, falling to 14% in the 1980s with rise after 1999 but still remaining below 20% in 2005. In contrast savings rates and investment rates in East Asia and the Pacific stood at 20% in 1965 but rose to over 30% throughout the 1970s, 1980s and 1990s (Serieux, 2008).

Empirically there have been some attempts to measure the fiscal cost of bank failures in SSA. The estimated cost of bank restructuring between 1984 – 1993 for 11 sub-Saharan African countries was between 7% - 15% of their GDP (Popiel, 1994).⁸ There has also been an attempt to measure the impact on GDP through a reduction in credit. It is estimated that in Ghana, growth fell from 3% in the five years before the crisis of 1983-89 to 2.5% in the three years after it (Goodhart, Hartmann, Llewellyn, Rojas-Suarez, & Weisbrod, 1998).⁹ The estimated levels of NPLs, the fiscal cost of restructuring and output loss due to reduction in GDP post bank failures for most SSA countries are listed in Appendix 1. It has been acknowledged that costs of bank failures are inherently difficult to measure and costs usually vary according to the measure used (Hoggarth, Reidhill, & Sinclair, 2004; Mayes, 2004). Nonetheless, these figures highlight the costs stemming from financial fragility and bank failures. From the high cost of recapitalizing banks, it can be deduced that the impact of fragility on depositors in SSA has been high.¹⁰

Table 1 shows that by regional standards the Kenyan banking system is relatively deep. In 2004, compared to the SSA average of 32%, the ratio of liquid liabilities to GDP was 38%, and the ratio of private credit to GDP was 24% in Kenya as compared to the SSA average of 18%. The intermediation ratio – the loan to deposit ratio is also relatively high at 73% compared to a SSA average of 66%.¹¹

However there are several areas for concern in terms of depth, efficiency and stability in the Kenyan banking sector.¹² In terms of depth as measured in terms of access to finance, surveys of firms in Kenya have identified access to finance as a major constraint

⁸ For Tanzania it is estimated that the fiscal cost of recapitalization was as high 40% of GDP (World Bank, 1994).

⁹ Another estimate for Ghana based on output loss as a percentage of GDP due to reduction in credit puts the figure at 15.8% (Caprio, Klingebiel, Laeven, & Noguera, 2005).

¹⁰ Refer to Chapter 4 for estimates of total deposits lost in failed banks in Kenya.

¹¹ It should be noted there is no consensus on what the ‘ideal’ level of loan deposit ratio should be. A higher ratio indicates higher intermediation efficiency but a ratio much higher than 100% would indicate that lending is funded from other sources besides deposits. The crisis in 2007 of the British bank Northern Rock highlights the problems of banks relying on non-deposit funding such a funding from the money market to give loans (Chick, 2008).

¹² A detailed analysis of the historical development of the banking sector in Kenya and the structure of the banking sector in Kenya is given in Chapter 4.

to firm growth.¹³ By constructing industry wide balance sheets of manufacturing firms in Kenya, it has been found that the majority of firms rely on equity and retained earnings for over 85% of their financing and only subsidiaries of multinational companies rely on credit for over 30% of their financing (Isaksson & Wihlborg, 2002). Furthermore, as shown in the table above, the ratio of private sector credit to GDP while higher than the SSA average is much lower than the ratio of East Asia of 30% or of high-income countries of 107%.

In terms of efficiency, while the interest rate margins in Kenya of 7.8% are better than the SSA average of 11.1%, they are still very high compared to the margins for East Asia and high-income countries stated above.¹⁴ One of the key problems of the Kenyan banking sector is the extremely high level of non-performing loans – even by regional standards. In Kenya in 2001, the average non-performing loans over total loans ratio stood at 41%. As displayed in Table 1, this level is much higher than the levels for Uganda of 6.5%, Tanzania of 12.2% and Ghana of 28.8%. This high level of non-performing loans also contributes to the fragility of the banking sector with 42 bank failures since 1984.¹⁵

1.3 Conceptual Framework – Segmentation and Relationships in Banking

The general aim of this thesis is to develop a deep understanding of the sources of shallowness and fragility of the banking sector in Kenya. In Chapter 3 we engage with the literature on finance in SSA. We show that because of the dominance of mainstream methodology and methods, these studies have limited power in explaining the poor performance of banking systems in SSA as described above. In particular, many studies attribute the poor performance of banking systems in SSA to the high level of concentration of the banking systems, which it is assumed leads to lower competition

¹³ There is a plethora of papers from the World Bank's Regional Program on Enterprise Development (RPED), which conducts surveys amongst small and medium enterprises (SMEs) in Africa and finds that access to finance is a major constraint facing SMEs. See www.worldbank.org/rped. This thesis only discusses access to finance in terms of access to formal finance. The low provision of financial services to the poor has been widely addressed in the microfinance literature and is not discussed in this thesis.

¹⁴ The world wide average for interest margins is 6.5% in 2004 (Cull, Fuchs, & Lovegrove, 2008).

¹⁵ Detailed list of bank failures in Kenya is given in Chapter 4.

and ergo poor performance.¹⁶ However, we reject this simplistic explanation and argue that the reasons for the high level of concentration also have to be explored and explained.

In contrast, this thesis begins with the recognition that the banking sector in Kenya is highly segmented on the basis of ownership and size factors. The four segments that we will identify on this basis are: foreign-owned banks (FOB), government-owned banks (GOB), local large private owned banks (LPOB) and local small private owned banks (SPOB).¹⁷ We show that not only is the overall performance of the banking system in Kenya poor, but within the banking system there is a differential performance between the FOB, GOB, LPOB and SPOB. While the poor performance of government owned banks has been well documented, we show the SPOB segment also performs poorly. This study analyzes each of the segments of the banking sector and attempts to understand the constraints faced across the sector (in all segments) and those faced by just certain segments to understand this differential performance.¹⁸ The key argument of this thesis is that the poor performance of the banking system is due to the segmented nature of the banking system and that this segmentation is based on social factors and in particular different levels of trust in each of the segments.

Within this framework of segmentation, this thesis studies three relationships: between a bank and its borrowers (lending relationship), between a bank and its depositors (deposit mobilization), and between the shareholders and management of a bank (corporate governance).

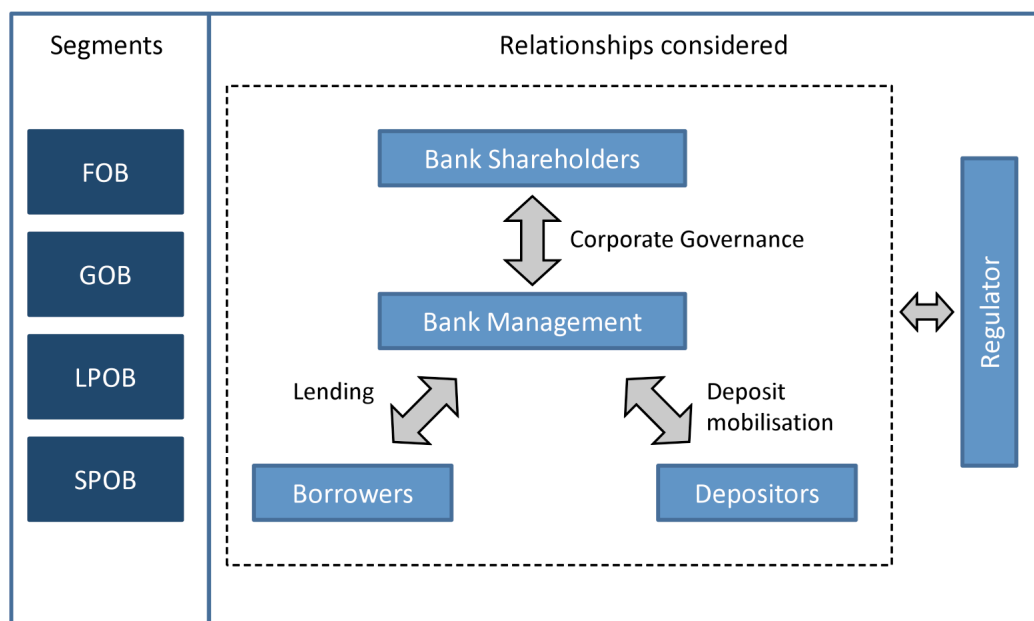
¹⁶ As we will discuss in Chapter 3, banking systems in SSA characteristically have 3 or 4 large banks controlling 60 – 80% of the market share.

¹⁷ Banks are classified as LPOB and SPOB, on an economic measure – the capital of the banks. Banks with a capital base of KShs. 1 billion (approximately USD 13.8 million at end of 2005 exchange rates) or more are classified as LPOB.

¹⁸ It should be noted that fragmentation of the financial sector between informal and formal finance has been well documented (Nissanke and Aryeetey 1998; Johnson 2005; Nissanke and Aryeetey 2006). However, very few studies have focussed on segmentation within the formal banking sector.

Figure 1 following provides a visual description of this framework and the relationships.

Figure 1: Framework of Analysis – Segments and Relationships in Banking Sector in Kenya



There is a fourth relationship that is extremely important in banking - the regulatory relationship. This thesis does not focus on this relationship mainly because there is already significant literature on the weakness in prudential regulation and supervision of banks in developing countries in general and Kenya in particular (Alawode, 2003; Barth, Caprio, & Levine, 2006; Brownbridge & Kirkpatrick, 2002; Brownbridge, Kirkpatrick, & Maimbo, 2005; Kagira & Kirkpatrick, 2001; Llewellyn, 2005). However, throughout the thesis, prudential regulations pertaining to lending, deposit mobilization and governance are listed where relevant, and the response by banks to this regulation is discussed.

1.4 Research Questions

The research questions with specific reference to each of the relationships are now detailed.

1.4.1 Lending Relationship

It is generally accepted in the literature that banks have particular expertise in processing information and monitoring borrowers (Freixas & Rochet, 1997).¹⁹ As will be shown in Chapter 5, the relationship between a bank and its borrowers is usually analyzed solely in terms of information asymmetry and the market imperfections that prevent the resolution of this information asymmetry (Stiglitz & Weiss, 1981).²⁰ This thesis argues this concept is limited and has to be extended to get a deeper understanding of the relationship. Chapter 5 outlines other theoretical concepts from Marxist, Post-Keynesian and Institutional schools that are useful in understanding the lending relationship – in particular the concept of knowledge creation and the embeddedness of credit relations in social relations (Dow, 1998; Johnson, 2005; Lapavistas, 2003; Uzzi, 1999). These theoretical concepts are used to analyze the qualitative data on lending relationships in the banking sector in Kenya. Furthermore, it has been argued that poor performance of banks in sub-Saharan Africa is due to their inability to gather sufficient information on borrowers and because they face a weak legal environment which prevents them from enforcing contracts (Aryeetey, 2003). Yet, there is little empirical work done to show how banks gather information and monitor borrowers and this study attempts to fill this gap in relation to the banking sector in Kenya.

The questions that we attempt to answer with reference to banks in Kenya are:-

- 1) How is information collected, what type of information is collected, and how is this information processed before a credit allocation decision is made?
- 2) What are the differences in credit allocation processes and monitoring that lead to differential outcomes in terms of good loans or bad loans?
- 3) What are the differences in the credit allocation process between different segments?
- 4) How do social relations affect credit relationships and how are these different amongst different segments?

¹⁹ Refer to Chapter 2.

²⁰ In other mainstream theories on finance and development, in particular the McKinnon-Shaw model, there is very little discussion on the relationship between the bank and the borrower (McKinnon, 1973; Shaw, 1973). It is assumed that key constraint is the level of resources available for lending and that an increase in interest rate will resolve this problem. Refer to further discussion on McKinnon-Shaw model in Chapter 2 and 3.

1.4.2 Deposit Mobilization

As will be shown in discussions in Chapter 3 and 5, the literature has paid very little attention to the relationship between a bank and the depositor. In mainstream literature, particularly the McKinnon-Shaw financial repression hypothesis, the relationship between the bank and its depositor is discussed. However, it is assumed that the only factor affecting the depositor is a price factor – the interest rate. Therefore, it was argued that replacing an artificially low government specified interest rate with market determined interest rate would lead to an increase in deposits (McKinnon, 1973; Shaw, 1973). We draw attention to alternative heterodox concepts including Chick and Dow's Post-Keynesian framework of stages of banking development (Chick, 1992, 1997; Dow, Ghosh, & Ruziev, 2008), which emphasize that the relationship between a bank and its depositor is based on trust. Therefore our study attempts to understand the factors that shape this trust and the nature of the constraints faced by banks when mobilizing deposits.

The questions that we attempt to answer with reference to banks in Kenya are: -

- 1) What are the main constraints faced by banks when raising deposits?
- 2) What are the differences in constraints between different segments in the banking sector in Kenya?

1.4.3 Corporate Governance

Recently, there has been an acceptance in the literature that corporate governance of banks affects their performance. However, the literature is dominated by mainstream literature where it is assumed that 'best practice' corporate governance is defined in terms of the Anglo-Saxon governance model of diffused share ownership and separation of ownership from management. In Chapter 7 this thesis discusses this literature and also considers alternative views on corporate governance and shows that empirically it is difficult to specify 'best' corporate governance practices. In Chapter 8, the thesis considers corporate governance of banks in Kenya in light of these debates.

The research questions that we consider in reference to the Kenyan banking sector are:-

- 1) What is the structure of ownership and management of the banking sector and how is this different across different segments of the banking sector?

- 2) What is the impact of international codes of corporate governance on the development of regulations on corporate governance in Kenya?
- 3) What is the impact of changes in regulations on corporate governance on the corporate governance practices of banks? Is the impact of these regulations different for different segments?

Having outlined the research questions, we now consider the ontology and data collection methods of this thesis.

1.5 Methodology, Methods, Data Collection and Data Analysis

1.5.1 Ontology and Methodology

Ontologically this research views the economy as an open system: that is, a system that is very complex and not all relevant variables are known, where boundaries of the system cannot be specified, where interrelation within the system changes and knowledge is rarely held with certainty (Dow, 2002). This is as opposed to a closed system, which is one where all the relevant variables can be identified, all boundaries specified, and where all relationships are either knowable or random and is the basis of mainstream work (Dow, 2002; Downward & Mearman, 2007).

The discussion of studies of finance in SSA in Chapter 3 shows that they are based on a closed systems ontology. In discussions with mainstream economists in Kenya, the methodology of this thesis was criticized, as there is no functional relationship specified a priori. It was argued:

“You need to be specific about what you are trying to explain – is it high interest rate spreads, high non-performing loans, low intermediation levels or bank closures? Say you pick non-performing loans, and then you can think of it in the following function form: The degree of loans going bad (X1) = f (trust, management of credit, efficiency of intermediation). As these cannot be measured quantitatively you need to think of which proxies you can use. As a proxy for trust you can use the length of relationship, as a proxy for management of credit you can use the qualifications of staff or for efficiency of intermediation you can use current assets / total assets etc..”

Kenyan Economist in interview with author ²¹

At an operational level, this method is not pursued due to a basic data constraint - information on individual non-performing loans and length of relationship between a bank and their client is considered confidential by banks and therefore not readily available. However, the main reason this methodology is not followed is an ontological one – it is too deterministic and unidirectional. Using an open systems ontology, this thesis also rejects the necessity to investigate the subject in terms of functional forms and causal relationships (Fleetwood, 2007).

The Kenyan banking system is shallow, inefficient and fragile and one of the main outcomes of this is the high level of non-performing loans, which this thesis attempts to understand. But it is impossible to disentangle and define a single, measurable dependent variable. High non-performing loans, high interest rate spreads and high levels of bank failures could all be considered a symptom of the fragility and therefore dependent variables. But equally they could be the cause of fragility and therefore be used as independent variables. Furthermore, we would like to emphasize that shallowness and fragility of the banking system are also interlinked. While shallowness and fragility are measured using different indicators, our research shows that shallowness contributes to fragility and vice versa.

Furthermore, it will be shown in Chapter 7, that empirically it is extremely difficult to define a single corporate governance variable that has a strong impact on performance.

²¹ All interviews are non-attributable and therefore each of the interviewees has been given a label.

Therefore, attempting to link a single corporate governance indicator in a functional form equation with performance would also be futile.

However, we recognize that all research involves some form of partial closure (Downward, Finch, & Ramsay, 2003; Mearman, 2003) and that there will be factors that affect the stability of the banking sector in Kenya that are not revealed by this study. Using an open systems ontology is also in line with one of the core concepts of this thesis - that segmentation of the banking sector in Kenya is both a cause and consequence of the fragility in the banking sector.

Ontology in economics has been mainly discussed by the Critical Realism School (Lawson, 1997, 2003). Political economists have criticised critical realism and argued that ontological and methodological concepts are developed independently of context, and therefore, critical realism is trans-historical (Fine, 2004). This thesis takes these criticisms into account and is firmly rooted in the specific context and experience of the Kenyan banking sector. However, the process of thinking about and stating the ontology of research has helped the author in the process of making the research more holistic and appropriate to the topic of study.

In an attempt to understand sources of financial fragility, this thesis follows heterodox methodology and methods. It follows other heterodox economists including Post Keynesians, Feminists and Marxists in having a ‘common sense view of the economy’. “Post Keynesians characterise their common-sense propositions by stating that the real (actual) economy is a non-ergodic, independent system with human agency and economic-social-political structures and institutions embedded in an historical process” (Lee, 2002 pp., 790). It is also grounded in a pluralist theoretical approach advocated by many heterodox economists.²² In Chapter 5, we discuss theoretical concepts from different schools that are useful in understanding lending and deposit mobilization. In Chapter 7 we engage critically with mainstream literature on corporate governance.

²² Also see Olsen (2006) who discusses how attempting to analyze a problem, in this case tenancy in rural India from three different theoretical schools – neoclassical, institutional and Marxist - allows a more in-depth look at the assumptions of each theory and leads to an improvement in dialogue regarding policy changes aimed at poverty reduction.

1.5.2 Strengths of Qualitative and Quantitative Data

The core of this thesis is based on semi-structured interviews of banks and analysis of qualitative data to understand each of the relationships described above – lending, deposit mobilization and corporate governance. While other social scientists – anthropologists, sociologists and political scientists - rely heavily on qualitative data, in economics, qualitative data generation techniques are normally rejected for not being ‘rigorous and objective’ (Harriss, 2002). As will be shown in Chapters 2, 3 and 7, this is reflected in the dominance of quantitative analysis in economic journals (Blin & Siegmann, 2006; Lee, 2007). This is also the view held by most African economists and the use of qualitative data in our research methodology was severely criticized in discussions with another leading Kenyan Economist.

However, qualitative data can be extremely useful. Miles and Huberman (1994) describe several strengths of qualitative data. For this author, the key strength of qualitative data is:

“their richness and holism, with strong potential for revealing complexity; such data provide ‘thick descriptions’ that are vivid, nested in a real context, and have a ring of truth that has strong impact on the reader”

Miles & Huberman (1994 pp., 10).

With specific reference to financial sector regulation the importance of qualitative evidence has been highlighted in a study of prudential regulation in Zambia. It is argued:

“The CAMEL model used by the Bank of Zambia during the banking crises offered a systematic framework for analysing bank performance. However, its lack of performance benchmarks and, more importantly, *non-quantitative* indicators of financial distress, and its sole focus on financial ratios means that it ignored a lot of indicators in the industry of distress that appeared long before the bank’s financial ratios began to deteriorate”

Maimbo (2002 , pp.271).²³

²³ Emphasis added

It is further argued that in Zambia, the excessive use of price based competition and overinvestment in Treasury bills highlighted the financial distress of weak banks long before financial ratios started to decline (Maimbo, 2002). The CAMEL model of understanding bank performance stands for Capital, Asset levels, Management quality, Earnings and Liquidity. The key point to note here is that one of the most important factors determining bank performance - the M for management - is extremely difficult to measure quantitatively.

We do not advocate an outright rejection of statistical and econometric studies as suggested by many in the Critical Realist school such as Lawson (1997). We concur with Downward and Mearman (2007) who argue that mixed methods analysis, where both qualitative and quantitative data is triangulated can be viewed as a form of retrodution which is the methodology espoused by critical realists. We also agree with Olsen & Morgan (2004) who make a distinction between methodology and methods. They argue that through the use of the method of multivariate regression, a researcher can still follow a retroductive methodology and interpret the results to form non-intuitive and non-atomistic explanations. However, it will be argued in Chapter 3, the majority of work done on the formal financial sector in SSA, which follows mainstream methodology and methods, does not meet these criteria.

For this study, quantitative data was collected and analyzed to reveal basic trends. Econometric analysis was not carried out due to the limitations of other econometric studies highlighted in Chapters 2 and 3.

Through the use of qualitative interview data, this thesis provides an alternative understanding of constraints of the banking sector in Kenya that are not revealed by looking at quantitative data. We particularly highlight how social factors and trust impact the performance of the banking system and these cannot be measured quantitatively. An extremely interesting parallel can be drawn between our methodological approach in which we use both quantitative and qualitative data and one of our key findings in Chapter 6 – in assessing credit applications, banks view hard (quantitative) and soft (qualitative) information as complimentary and not substitutes.

1.5.3 Summary of Data Collected

Empirical analysis in this thesis is based on semi-structured interviews of directors and senior management of 7 banks in Kenya carried out in the summer of 2006. These included one foreign owned bank (FOB), one government owned bank (GOB), three large private owned banks (LPOB) and two small private owned banks (SPOB).²⁴ The questions used are listed in Appendix 2 and covered three main areas – lending and non-performing loans, deposit mobilization and corporate governance. The interview questions were designed keeping in mind the theoretical concepts on lending and deposit mobilization discussed in Chapter 5 and the concepts on corporate governance discussed in Chapter 7. The semi-structured interview questions were discussed and reviewed by two respected Kenyan economists and one senior banker and adjusted before the interviews were conducted with bank staff.

Quantitative data collected included the summary of audited financial statements (balance sheet and profits and loss) of all banks in Kenya from 2000-2005. A list of the variables collected is given in Appendix 3. We also developed a database on corporate governance indicators for all Kenyan banks from 2000-2005 directly from banks' financial statements. The list of variables collected is given in Appendix 4.

1.5.4 Limitations of Data Collected

Several problems were faced and these limitations should be kept in mind throughout the thesis. With reference to the quantitative data on banks' financial statements, this was not available in a consolidated form from the Central Bank of Kenya (CBK). This would have been ideal, as the total figures in this dataset would have matched with total figures in the CBK's supervision reports. Therefore the dataset used was from a Kenyan business magazine – Market Intelligence. This business magazine publishes an annual report on the banks in Kenya and they prepare the dataset from accounts of banks published in the newspapers. We took great care to check the data, and for all years, the summary balance sheet and profit and loss data was verified directly with a hard copy of actual banks' financial statements, which were obtained from the Central Bank of Kenya.

²⁴ The literature on banking in Africa for example Brownbridge & Harvey (1998) use the term *government* owned banks, however literature from other regions for example China refers to these as *state* owned banks. In this thesis, the term government owned banks is used where the state is the majority shareholder.

There were several errors in this dataset that we corrected.²⁵ However, there are a few gaps in the database where we were not able to obtain financial statements of the banks.

With reference to the qualitative data several limitations were faced. First, there was no random sampling in the choice of banks interviewed. The only criterion used was the willingness of the banks to be interviewed. However, we ensured that we had at least one bank from each of the segments identified at the start of the fieldwork. The resulting sample of banks therefore followed a mix of replication logic and sampling logic (Yin, 2003).²⁶

Second, bankers were very busy and often not willing to spare more than an hour per interview. Therefore for some banks, certain questions in the semi-structured interviews were skipped. For some banks, we were able to interview only two people in a bank and in others five different people answered the questions. Third, there is a high turnover of bank staff in Kenya. Therefore, some of the bank managers interviewed had been in the position for less than six months and often did not know the past history of the bank. Fourth, bank managers were very cautious when talking about 'current problems'. They preferred to talk about 'what went wrong in the past' and 'what had been changed' and 'strategies for the future'. In particular the answers to questions on the level of insider lending, were so vague, that it was impossible to get any meaningful insight from them. Fifth all banks were very categorical that they did not want to 'be quoted' and would only participate in the interviews if their names were not revealed. Therefore interview data is non-attributable. Each bank is given a number (Bank 1 to Bank 7) and also a segment tag (FOB, GOB, LPOB, SPOB). Also, the banks were not willing for the interviews to be recorded. Therefore, there may be some human errors in the transcription. Sixth, the GOB interviewed was not very keen to discuss governance measures or political interference that had led to high levels of non-performing loans.

²⁵ The main error was when a bank had subsidiaries outside Kenya. The dataset was not consistent and sometimes the figure of the bank was quoted and sometimes for the whole group. We consistently used the data for the Kenyan operations only.

²⁶ Selection of cases based on replication logic is the process whereby cases are chosen because similar observed outcomes in all the cases. Evaluation then attempts to look for similar processes that took place in each of the cases as explanations for the outcomes. Selection of cases based on sampling logic is different as cases attempt to represent a broader universe therefore chosen according to representation criteria (Yin, 2003).

The interviewees kept re-iterating that they had undergone several reforms and were free from political pressure in terms of lending decisions. Therefore the discussion in non-performing loans of GOB in this thesis relies heavily on secondary data.

The main shortcoming with this thesis was that we found it impossible to speak to any of the statutory managers / liquidation agents appointed by Deposit Protection Fund Board (DPFB) to manage and liquidate failed banks. DPFB required the author of this thesis to get a letter from the Office of the President approving this research and this permit was not possible to obtain due to time constraints. Furthermore, the Central Bank of Kenya only gives very general information in the supervision reports and does not even name the banks that have failed.²⁷ This has meant that the possibility of comparing the lending practices of failed banks with surviving banks, which would have formed an interesting case study, has not been possible.

1.5.5 Data Analysis

In general this study follows a comparative case study approach. “A case study is defined as an in-depth, multifaceted investigation into a particular object or theme, where the object or theme gives it its unity” (Lee, 2002 pp., 799). Case study approach is appropriate when a phenomenon is not easily distinguishable from its environment (Yin, 2003). It is particularly applicable when there are more variables than data points (Yin, 2003). Therefore, this method is best suited to understand the research questions outlined above. However, it should be noted that as the interviews are non-attributable, this is not a typical case study approach.

Even advocates of case study approach highlight that it is difficult to generalize and compare or generate theories from this type of research (Blaikie, 2000). This study refers to theoretical concepts before attempting to make generalizations. Furthermore, when generalizations are made, they refer specifically to the context of the banking sector in Kenya and generalizations are not attempted for other African countries.

²⁷ Detailed list of bank failures in Kenya is given in Chapter 4. For example, the report for 1998 simply states: “During the year, 5 banks were placed under statutory management” (Central Bank of Kenya, 1998).

Data analysis generally followed the advice of Miles and Huberman (1994). After the interviews were transcribed, general patterns were detected in the data. The data was coded and a summary of the coding was used to make the tables in Chapter 6 and Chapter 8.²⁸ After that, we worked back and forth, extending the coding and going back to theory. Generalizations were made when each segment reflected some of the same constraints. This methodology reflects our open systems ontology.

1.6 Structure and Contributions of the Thesis

In this chapter we discuss the background and context of the study. We also define the framework of research – we are trying to understand the reasons for the shallowness and fragility of the banking sector in Kenya by exploring the nature of segmentation of the banking sector in Kenya and how this segmentation affects lending, deposit mobilization and corporate governance of banks. We then discuss the research methods and explain our reasons for focussing on qualitative interview data. The rest of the thesis consists of eight chapters.

Chapter 2 discusses the main schools of thought and debates on the role of finance in economic development. The chapter provides a synthesis of the literature on the key functions finance can play in the economy, but underlines that the literature is weak in trying to explain the specific institutional constraints that prevent finance from fulfilling these functions. Chapter 3 is a methodological critique of the current literature on finance in SSA. It argues that due to the overwhelming reliance on mainstream methodology and quantitative methods, this literature is severely limited in its ability to understand and explain finance in SSA.

Chapter 4 begins by exploring the establishment of banking in Kenya, followed by a discussion of present day performance and ownership structure. The chapter then carries out a critical review of studies on the banking sector in Kenya. In line with other studies in SSA this chapter shows that due to the reliance on mainstream methodology and methods, the literature on the banking sector in Kenya is deficient. Our historical analysis shows that not only is the banking sector in Kenya highly concentrated, but that the first three banks to be established, between 1896 and 1910, remain the three dominant banks in 2005. We argue that this dominance is based on high levels of trust

²⁸ Initially the tables were made a bank specific level and then consolidated at segment level.

that borrowers and depositors have in these banks, and explaining this dominance is essential to understanding the reasons for the shallowness and fragility of the banking sector. The chapter analyses financial statement data on the four segments - FOB, GOB, LPOB and SPOB – and shows that the performance between these segments is differentiated. FOB have good performance in terms of low non-performing loans, while GOB and SPOB have relatively high non-performing loans. We show that LPOB have been able to increase their market share while SPOB have lost their market share. Most importantly we show that the cost of funds and spreads are highly variable. While mainstream theory would infer that as the best performers, FOB would have the lowest spreads, we show, that they actually enjoy the highest spreads. GOB also enjoy high spreads even though overall they are poor performers. And SPOB are poor performers but they enjoy very low spreads. Using qualitative data and understanding the nature of lending and deposit mobilization is key to explain these conflicting and variable performances.

Following a pluralist methodology, Chapter 5 discusses theoretical concepts from Marxist, Post-Keynesian and Institutional schools that are useful in understanding lending and deposit mobilization relationships. These include knowledge creation and the embeddedness of credit relations in social relations and stages of banking development framework (Chick, 1992, 1997; Dow, 1998; Dow et al., 2008; Johnson, 2005; Lapavistas, 2003; Uzzi, 1999).

Chapter 6 uses these theoretical concepts and analyzes the interview data to reveal that the constraints faced by different segments. The analysis shows that different segments of the banking sector face clients of significantly different size and type, and that this segmentation has a strong impact on performance of banks in each of the segments. The analysis shows that segmentation is based partly on economic factors such as the size of banks and structure of ownership, but largely on social factors that determine the trust between banks and their clients. The chapter demonstrates that due to segmentation, there are varying 'radiuses of trust' within one banking system and that segmentation is a result of fragmentation rather than specialization. The key contribution of the chapter is to show that segmentation affects lending decisions, deposit mobilization and governance of banks and therefore the structural constraints faced by banks in Kenya are varied, complex and grounded in social factors.

Corporate governance is viewed as a method to improve performance of firms and banks and therefore, Chapter 7 is a critical review of corporate governance literature with reference to banks and shows that empirically there is very little consensus on what constitutes 'best' corporate governance practices. Chapter 8 analysis a data set of corporate governance variables that we have collected and interview data. The chapter shows that the new regulation on corporate governance that attempts to enforce 'best' practice standards on banks in Kenya and will have little impact on the performance of banks because they do not consider the structural features and segmentation of the banking sector. Chapter 9 synthesizes the conclusions of the empirical chapters and identifies key areas for future research.

CHAPTER 2 – FINANCE AND DEVELOPMENT

2.1 Introduction

This chapter reviews the main schools of thought and debates on the links between finance and development. Section 2.2 discusses the studies on the links between finance and growth and Section 2.3 the debates on financial system design. Studies on bank failure and financial fragility are discussed in Section 2.4 while Section 2.5 provides the concluding remarks to this chapter.

2.2 Debates in Finance and Development I – Finance and Growth

Is financial development an engine for economic growth? The proponents of finance and growth focus on cross country evidence. It is argued that:

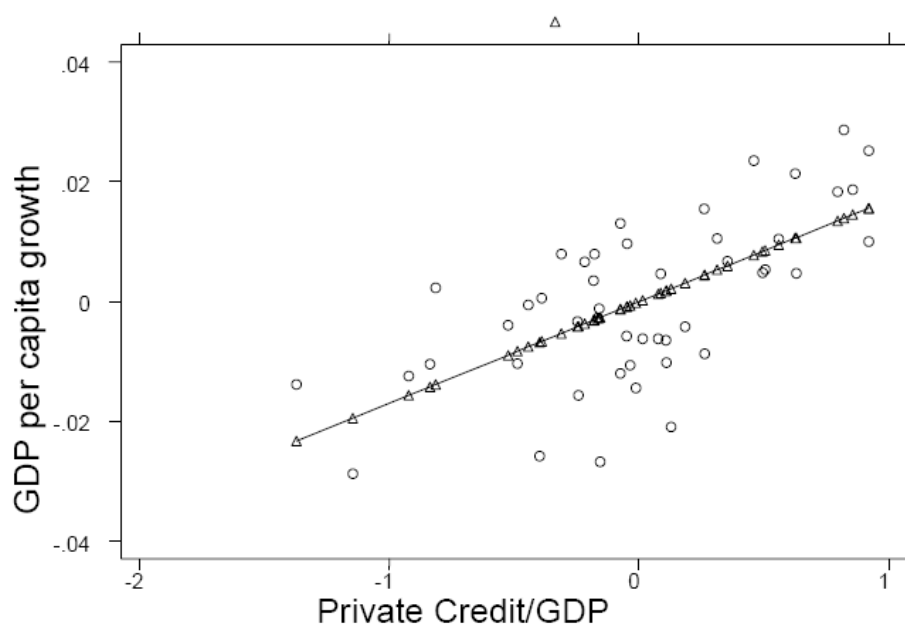
“Cross-country comparisons have shown the importance of a well-developed financial sector for long-term economic growth and poverty alleviation. Countries with better developed banking systems and capital markets enjoy higher growth rates.”

Beck and Levine (2004)²⁹

They refer to graphs of cross-country data that display a positive relationship between financial development and growth. An example of such a graph is displayed in Figure 2.

²⁹ This paper was written when the authors, Beck and Levine, were both working at the World Bank. In general, the majority of World Bank economists are proponents of the school that financial deepening leads to growth.

Figure 2: Cross Country Evidence on the Links between Financial Development and Growth 1960 - 1999



Source: Beck and Levine (2004)

The existence of an interrelation between financial deepening and growth has been recognized in early works including Goldsmith who constructed a financial interrelation ratio and showed that this ratio grew with a country's economic growth (Goldsmith, 1969).³⁰ However, Goldsmith was cautious in interpreting this interrelationship as causation. Another early paper also highlighted this association between financial development and growth:

“An observed characteristic of the process of economic development over time, in a market-oriented economy using the price mechanism to allocate resources, is an increase in the number and variety of financial institutions and a substantial rise in the proportion not only of money but also of the total of all financial assets relative to GNP and to tangible wealth. However, the *causal nature* of this relationship between financial development and economic growth has not been fully explored either theoretically or empirically”

Patrick (1966 pp., 174).³¹

³⁰ This ratio is calculated by dividing the total value of all financial assets by the total value of tangible assets plus net foreign balance.

³¹ Emphasis added.

This observation seems as relevant today as it did in 1966. There are several papers that attempt to explain a causal link between financial development and growth. The key role of financial institutions is intermediation – transferring assets from savers to borrowers. Levine (1997) and Freixas & Rochet (1997) provide summaries of the existing contemporary theoretical literature and focus on a causal link between finance and growth in terms functions of finance and the role of intermediaries in reducing information costs and transaction costs.³² Due to adverse selection and moral hazard issues, information costs and transactions costs can never be zero in any realistically defined financial market and therefore intermediaries are more efficient than individuals in transferring assets (Stiglitz & Weiss, 1981).³³

The figure below summaries the theoretical links between finance and growth.

³² They summarize several seminal works including: -

Gurley and Shaw (1960), Benston and Smith (1976) and Fama (1980) consider how banks transform assets;

Diamond (1984) and Holmström and Tirole (1993) which considered banks as delegated monitors;

Freixas and Rochet (1997) consider how economies of scale and scope prevent individuals but allow banks to play a financial intermediation role;

Diamond and Dybvig (1983) which considers banks as “pools of liquidity” that provided households with liquidity insurance;

Leland and Pyle (1977), Diamond (1984) and Ramakrishnan and Thakor (1984) which interpret banks as information sharing coalitions;

Boyd and Prescott (1986) and Greenwood and Jovanovic (1990) emphasize the screening role of intermediaries and the pooling of idiosyncratic investment risks which stimulates growth;

Bencivenga and Smith (1991) emphasize how financial intermediation reduces the need for project liquidations and therefore stimulates growth; and,

Pagano (1993) emphasizes the impact of financial innovation on growth.

³³ Adverse selection is defined as the tendency for any contract offered to all comers to be most attractive to those most likely to benefit from it. For example, if an insurer offers health insurance without any medical examination, the expectation is that people with poor health prospects are likely to accept it, while people with better health prospects, who can get better terms from a more selective insurer, will reject the unconditional contract. In trying to be non-selective, adverse selection causes the worst risks to select themselves. Moral hazard is defined as the danger that if a contract promises people payments on certain conditions, they will change their conduct so as to make these conditions more likely to occur. For example, moral hazard suggests that if possessions are fully insured, their owners are likely to take less good care of them than if they were uninsured, or even to connive at their theft or destruction (Law & Smullen, 2002).

Figure 3: Theoretical Links between Finance and Growth



Source: Levine (1997)

The main functions financial intermediaries play that facilitate economic growth are: -

- Encouraging saving – by providing a return on saving, financial intermediaries play a key role in mobilizing savings.
- Efficient allocation of resources – specialised financial institutions are better able to get information on borrowers, select projects and provide ongoing monitoring of projects and ensure that contracts are enforced.
- Agglomerating capital – economies of scale means that institutions more efficient than price mechanism in playing the intermediation role.
- Pooling Risk - providing liquidity and converting short-term liabilities to long-term assets, that is, maturity transformation.

There still remains a debate on the direction of causality. Robinson (1952) argued that the causality runs from economic growth to financial deepening: where enterprise led, finance would follow. Marxist economists for example Aybar and Lapavitsas (2001) have argued that “far from being the driving force of financial accumulation, the financial system is an outgrowth of accumulation of industrial and commercial capital”. Patrick (1966) suggests that the relationship is not linear. In the early stages of development, financial development may lead to growth, but in later stages, growth is likely to determine the speed of financial development.

There are several empirical studies that find a positive relationship between financial deepening and growth (Fry 1978; Harris 1979; Lanyi & Saracoglu 1983; Fry 1988; Gelb 1989; King & Levine 1993a, 1993b). However, empirical tests conducted by other economists failed to find support for this relationship, as they find that growth co-existed with negative real interest rates (Agarwala, 1983; Khatkhate, 1988). Evans, Green et al. (2002) combine the finance and growth literature with the more traditional

endogenous growth models inspired by Romer (1986) and Lucas (1988).³⁴ They find that financial development is *at least* as important as human capital in the growth process.³⁵

The finance and growth empirical studies should be treated with caution at a theoretical level. They are generally based on the work of McKinnon (1973) and Shaw (1973) who postulated positive relationship between financial deepening and growth. In their work, which has come to be referred to as the financial repression school, they advocated financial liberalization and in particular the removal of government controlled low interest rates. The causal mechanism in the McKinnon-Shaw hypothesis between finance and growth is high (market driven) interest rates, which increases savings. It is argued “high rates of interest for both lenders and borrowers introduce the dynamism that one wants in development, calling forth new net saving and diverting” (McKinnon, 1973 pp., 15). However, the empirical studies do not explain the causal link from savings to financial development, and in turn, to growth. Empirical studies have focused on either one of the links - either on the link between monetary aggregates (as a measure of financial development) and growth; or the link between savings and growth (Mavrotas, 2005).³⁶ Evidence from research on post liberalization suggests that the relative size of the financial sector has had little impact on savings (Mavrotas, 2005).³⁷

At a methodological level, several arguments can be raised about these papers. By its nature regression analysis works within a closed system where it is assumed that all variables are known and measurable. We concur with Kenny and Williams (2001) who carry out a large survey of the growth literature and argue that:

“..any account which takes as an assumption that the process of economic growth works more or less unaltered across enough countries to be proved or disproved through the statistical testing of variables in large cross country regressions is likely to be inadequate”

Kenny & Williams (2001 pp., 2).

³⁴ The model uses a translog production function rather than the normal Cobb-Douglas production function and covers 82 countries for a period of 22 years.

³⁵ Emphasis added.

³⁶ See Mavrotas (2005) for a summary of the debates.

³⁷ The impact of financial liberalization on SSA and Kenya is discussed in more detail in Chapter 3 and Chapter 4.

Therefore econometric studies by their nature will have disappointing results as they assume that the process of development is homogenous, whereas history has shown that it is highly heterogeneous (Kenny & Williams, 2001). The criticisms levied by Kenny and Williams (2001) against growth equations in general, can also be levied against the finance and growth studies mentioned above. First, the studies are ahistorical. Even more complex studies, like Evans, Green et al. (2002) mentioned above, covers a period over which the role of finance in the world economy changed dramatically yet the study does not account for this. Concerns can be raised in the reference to leap between correlation and causation, the quality of data, and the large number of variables that are put into the regressions (Kenny & Williams, 2001). While the reliance on quantitative methods is based on the need to be objective, most of the indexes constructed to measure institutional conditions are based on subjective criteria (Cramer, 2002, 2003). At an ontological level, these studies can also be criticised as by its nature, regression analysis works within a closed system and looks for unrealistic ‘empirical regularities’ across the world (Dow, 2002).

Even though the literature on the link between finance and development is mammoth, the movement towards large quantitative regressions has meant that attempts to show correlation between finance and growth have become more important, than attempts to understand the exact mechanisms through which finance leads to development either empirically using either quantitative or qualitative data.

We concur with Moss (2003) who has argued:

“To a certain degree, all of the economic research seeking to explain the “causes” of economic growth in poor countries may be a futile search for the holy grail of development. Although studies considered above attempt to draw connections between financial systems and economic growth, there is in fact a host of other variables that an army of economists is exploring”

Moss (2003 pp., 73).

It should be recognized that heterodox economists also concur that financial intermediaries fulfill important functions that facilitate the economic process. However, they stress that the complexity of the links. We concur with Ruziev (2006) who has argued:

“In general, a more cautious suggestion is that economic development can occur without financial deepening, and financial development may not always lead to economic development. The former centrally planned economies of the socialist camp reached a considerable degree of economic development without any financial deepening. Whereas, although some offshore centres have developed sophisticated financial systems, economically they are still underdeveloped economies”

Ruziev (2006 pp., 91).

But, this brings us back to the key point on the role of banks – it is the intermediation by banks determines whether these savings are actually turned into investment. Schumpeter (1911) was an early proponent of the importance of finance for innovation, growth and development:

“The banker, therefore, is not so much primarily a middle man in the commodity “ purchasing power” as a *producer* of this commodity....He makes possible the carrying out of new combinations, authorizes people, in the name of society as it were, to form them. He is the ephor of the exchange economy”

Schumpeter (1911 pp., 74).³⁸

2.3 Debates in Finance and Development II – Financial System Design

Another area of debate in the literature concerns the design and structure of financial system matters for economic growth. A key problem with the graph in Figure 2 is that it does not capture the heterogeneity in the design of the financial system of countries that are in the top right hand corner of the graph. Therefore, some countries for example Germany and Japan have more bank based financial systems. Whereas, some countries for example the UK and USA have more market based systems. Proponents of the bank- based view argue that banks are better at performing the monitoring and

³⁸ The use of this word by Schumpeter is extremely interesting. Ephor refers to each of the five magistrates elected by Spartans in ancient Greece. However this notion of a banker as an overseer of the exchange economy is often in conflict with the notion of bankers who take excessive risk leading to fragility in the economy as a whole.

screening role of intermediaries (Stiglitz, 1985). It is argued that stock markets suffer from free-rider problems and inability of small stockholders to discipline managers leading to an inefficient allocation of savings (Stiglitz, 1985).

Ajit Singh who is one of the most fervent critics of stock markets argues that bank-led growth is more appropriate for developing countries whereas stock markets would bring more instability to already fragile economies (Singh 1992, 1997; Singh & Weisse 1998). Some authors find evidence for the disintermediation view – where the intermediary role of the banks is undermined by financial markets (Jeucken, 2001). Using a cross-country model with an interaction effect between stock market development and bank development authors find a negative interaction. That is the impact of banks on growth becomes less positive the higher the level of stock market development (Deidda & Fattouh, 2005).

Though these arguments have been criticised as being “too alarmist”, there is also a recognition that overstating the potential role for stock markets can also be dangerous (Moss, 2003). Even in the mainstream literature, there is now a recognition that starting stock markets in SSA has not led to the expected increase in financing for firms (Honohan & Beck, 2007; Lin, 2009).

We would like to argue that, while the role of stock markets in generating long term finance for enterprises in sub-Saharan Africa has been overstated, they do serve an alternative channel for personal and institutional saving and diversification as shown by the high level of interest in initial public offerings (IPOs).³⁹ Furthermore, the existence of stock markets and bond markets allows alternative sources of borrowing both for governments and institutions. However, there needs to be a recognition that stock markets in developing countries are not a neutral allocating mechanism. As argued by Harris (1994):

“Economies in the process of transition are fragmented to a different degree from established capitalist economies so that greater differences in monopolistic power and rent accumulation occur. Participants in stock

³⁹ For example, the IPO the mobile phone company Safaricom in Kenya in June 2008, was five times oversubscribed and the government manages to raise KShs. 50 billion or US\$ 715 million (Ewing & Barclay, 2008).

exchange activities form one stratum with the ability to extract rents from their dealings in securities whose price, on thin markets, fluctuates without relation to ‘underlying fundamentals’. The degree of fragmentation and both the thinness and narrowness of the markets means that dealing cannot be considered as equilibrating arbitrage.”

Harris (1994 pp., 18)

This is in stark contrast to recent literature by the World Bank entitled “Making Finance Work for Africa” which continues to argue:

“Financial development can help broaden the elite class because wealthy and middle-class people can acquire a share in the success of local economic ventures and begin to define their own prosperity in terms of national prosperity without reference to ethnic or local advantage. One concrete example is the way in which national elites have become interested in the fortunes of recently privatized firms.....If elites are invested in national economic prosperity..., they may work harder to introduce policies that underpin economic growth”

Honohan and Beck (2007)

As we have argued elsewhere there is evidence that the elites close to the Kibaki government in Kenya amassed phenomenal wealth through the Nairobi Stock Exchange (NSE) in a very short period of time between 2002 and 2005 and one cannot rely on the stock exchange to enforce governance or ensure equitable distribution of wealth (Upadhyaya, 2008).⁴⁰

However, we concur with Nissanke and Stein (2003) who have argued that the challenge of finance in developing countries is much more profound than simply an issue of bonds vs. stocks vs. bank lending as a source for productive investment and the need for financing so severe that no single source of financing should be ruled out.

⁴⁰ Chapter 4 discusses the developments of the banking sector in Kenya but also details the different political leaders in post Independence Kenya.

Finally, there has been a development in the mainstream literature called the ‘financial services’ view. They argue that the debate should not be between bank based vs. market based finance, but about developing an enabling environment in which financial institutions can fulfill their functions and services (Beck & Levine, 2002; Demirgüç-Kunt & Levine, 2001; Levine, 2002). This recognition should have provided a positive impetus for the literature to move in the direction of developing a deeper understanding of financial institutions in a context specific basis. Instead, the debate has got mired in the law and finance debate.

The law and finance school was first propagated in what is now considered a seminal paper by La Porta, Lopez-de-Silanes, Shleifer and Vishny now popularly known as LLSV (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). The school divides the world into two ‘families’ of legal origin - common law vs. civil law. The paper showed an association between legal origin and financial development – common law countries had better financial development indicators. It was argued that common law countries share certain properties – specifically better shareholder protection and creditor rights, leading to better access to finance for firms and in turn economic growth (Beck, Demirgüç-Kunt, & Levine, 2003; Beck & Levine, 2004; Bruno & Claessens, 2007; La Porta et al., 1998; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000).

It should be noted that this literature has largely been based upon cross-sectional studies of the quality of corporate and insolvency law at specific points in the late 1990s. Recent panel data work has begun to question this view. A recent large study, constructs more complex indices which track legal changes over time in the areas of shareholder rights for the period 1995-2005 for 20 developed and developing countries.⁴¹ They found that while common law countries had more shareholder protection, civil law countries during the period were catching up. They also found no evidence for the link between shareholder protection and stock market development casting doubt on the key claim of LLSV that shareholder protection leads to financial growth (Armour et al., 2008).⁴²

⁴¹ The countries are Germany, France, UK, US, Japan, China, India, Pakistan, South Africa, Malaysia, Canada, Spain, Mexico, Argentina, Chile, Italy, Switzerland, Brazil, Latvia, Czech Republic (Armour, Deakin, Sarkar, Siems, & Singh, 2008).

⁴² A similar study covering a longer period 1970 – 2005 but 5 economies UK, France, Germany, the US and India also found very little evidence that shareholder rights and also creditor rights were weak in civil law origin countries (Armour, Deakin, Lele, & Siems, 2007).

In another study, using a dataset of shareholder protection consisting of 60 annual legal indicators for the period 1970-2005 in France, Germany, the UK and the US for the period 1970 – 2005, changes in the legal system and shareholder protection are analyzed using principal component analysis (Fargernas, Sarkar, & Singh, 2007). This study finds evidence that common law countries do not necessarily have better shareholder protection than civil law countries (Fargernas et al., 2007).

These two studies raise two very important methodological issues with the law and finance school. First, relationships that hold across countries at certain points in time are lost when looking at time series analysis (Fargernas et al., 2007). Second, dividing the world in two large families masks the great diversity in institutional arrangements within each country and how these institutions evolved (Armour et al., 2007; Armour et al., 2008).⁴³ The problem is not that the law and finance school underlines that legal mechanisms are important for finance, but that ‘legal origin’ can be so neatly divided.⁴⁴ The above arguments further emphasize the need to understand the evolution of a country’s legal system on a country-by-country basis and to understand what are the specific strengths and weaknesses of the legal system that support the financial sector.

Heterodox economists have emphasized the time consuming nature of the institutional development of banking (Dow et al., 2008; Ruziev, 2006). In Chick and Dow’s Post-Keynesian framework of stages of banking development, there is an emphasis on how banks evolve over time from pure intermediation to credit creation (Chick, 1992, 1997; Dow et al., 2008). A summary of the seven notional stages has been detailed in Appendix 5.⁴⁵ The framework stresses the complex institutional characteristics that are

⁴³ It should be noted that the studies by Fargernas *et al.* (2007), Armour *et al.* (2007) and Armour *et al.* (2008) while useful in highlighting the problems of the LLSV school, still suffer from the problems of large cross country studies as discussed above in section on finance and growth. However, it seems that the authors are at least aware of the value of doing specific country case studies. Armour & Lele (2008) is an extremely thoughtful piece on the evolution of financial regulation in India which emphasizes the political explanations and the role of interest groups in influencing legislation as opposed India’s common law heritage.

⁴⁴ The LLSV and related literature reflects a general trend in mainstream economics of the excessive use of econometrics and in turn, the tendency by economists to look for binary relations - such as common law vs. civil law, or greed vs. grievance in the literature relating to civil war - which are easier to test using econometric methods.

⁴⁵ The seven stages are: stage 1 - pure financial intermediation; stage 2 - bank deposits used as money; stage 3 - inter-bank lending; stage 4 - lender-of-last-resort facility; stage 5 - liability management; stage 6 -

necessary for banks to play their full intermediation role. Therefore, rule of law is only one of the institutional conditions that is important for financial development. We would like to highlight the framework's emphasis on the necessity for the public to have full *confidence* in banks and the Central Bank before bank liabilities are accepted as a means of exchange. As will be discussed in Chapter 5 and 6, a key source of the segmentation of the banking sector in Kenya is differences in confidence and trust levels that the public has in different segments of the banking sector.

2.4 Bank Failures and Fragility – Theoretical and Empirical Studies

Bank fragility has been analyzed by looking at the special nature of banks that make them vulnerable to panics. Banks are different from normal firms on both the assets and liability side.

Like any profit-oriented organization, a bank faces two problems – illiquidity and insolvency. A bank is said to be illiquid when it cannot meet the liabilities that are coming up for repayment (Soyibo, Alashi, & Ahmad, 2004). However, the balance sheet of a bank is quite different from a representative firm. A simplified balance sheet of a bank is displayed in Figure 4.

Figure 4: Simplified Balance Sheet of a Bank

Asset	Liability
Reserves	Deposits
Loans	Capital

Source: Rochet (2008)

The fractional reserve banking system involves banks financing illiquid assets (long term loans) against liquid liabilities (short term deposits) and it is that makes them vulnerable to runs (Klausner & White, 1993). Generally a breakdown in trust that would lead all depositors to withdraw their funds at once – a bank run - would lead to illiquidity and extended illiquidity can lead to insolvency. Deposit insurance and lender of last resort

securitization; and stage 7- market structural diffusion (Ruziev, 2006). The last two stages were added only in Chick's and therefore an indication that the process of evolution of the banking sector is still taking place (Ruziev, 2006).

measures have been put in place precisely to counter this inherent instability in the banking system⁴⁶. Yet, the jury is out whether these facilities may compound the moral-hazard problem by transferring the risk to the tax-payer (Arun & Turner, 2004; Vives, 2001).

Despite leaving the system vulnerable to runs, this short term debt (deposits) has been considered in the literature as an important monitoring and market disciplining mechanism (Calomiris & Kahn, 1991; Diamond & Dybvig, 1983). This market disciplining mechanism does not always work. Rochet (2008) makes a distinction between a fundamental run which is efficient and a speculative run which is inefficient. It has also been recognized that the wide dispersion of depositors and the free rider problems (Freixas & Rochet, 1997) and opaqueness of banks financial statements (Mayes, 2004) often prevents depositors from playing this role.

On the asset side, moral hazard has also been used to analyze why banks owners may take excessive risk which would jeopardize the solvency of the bank (Brownbridge 1998a; Vives 2001; Senbet & Otchere 2005). First, the highly leveraged nature of a bank with limited liability, means that the downside risk is low compared to the upside gains. This induces banks to take more risks (Vives, 2001). In other words, moral hazard and bank capital are inversely related and furthermore, financial distress itself worsens these incentives (Berger *et al.* 1995; Brownbridge 1998a; Senbet & Otchere 2005). Moral hazard is worsened by other factors: for example, high deposit rates lead to banks to charge higher lending rates encouraging borrowers to also adopt a high risk strategy (Stiglitz & Weiss, 1981). A low level of diversification of the loan portfolio due to structural factors of the economy would also lead to a risky portfolio. This factor is particularly prevalent in developing countries where markets are segmented and lending is concentrated to firms within one industry (Brownbridge, 1998a; McKinnon, 1988). Recently there has been a lot of literature focusing on the East Asian financial crises where banks runs are analyzed as part of a wider economic crises where currency and financial crises are inter-related (Nissanke & Stein, 2003). For an extended literature

⁴⁶ In particular speculative runs or runs based on rumour and form the rationale for lender of last resort facilities provided by Central Banks.

review see Nissanke and Stein (2003). Currency crises have not played a role in financial crises in Africa therefore this literature is not reviewed here.⁴⁷

There have been several cross-country econometric studies assessing the causes of bank failures. Using a multivariate logit econometric model Demirgüç-Kunt and Detragiache (1997) analyze the factors that increase the probability of bank failures occurring. They find that bank failures are more likely when economic growth is low, inflation is high, real interest rates are high, the country has an explicit deposit insurance scheme and that there is weak law enforcement (Demirgüç-Kunt & Detragiache, 1997). However as it is the problem with econometric studies of this nature several possible explanatory factors are not considered – all variables related to the financial system such as the capitalization of banks are not included in the specification of the model.⁴⁸

Caprio and Klingebiel (1996) also carry out a cross country analysis of factors affecting bank failures.⁴⁹ They find that some of the factors that could precipitate bank failures include excessive credit growth, volatility in output and prices combined with shallow financial markets and reduction in franchise values or profitability of banks. Again, methodological issues can be raised with this sort of work where the authors are looking for unrealistic ‘empirical regularities’ across the world (Dow, 2002). As the authors themselves admit, “the rate at which credit growth becomes excessive and the amount of time it needs to persist before being clearly indicative of a problem are difficult to gauge” (Caprio & Klingebiel, 1996).

Honohan (2000) categorises bank crises into 3 main types depending on the symptoms displayed – epidemic macro crises (associated with a macro shock), endemic failures (associated with high government intervention) and epidemic micro crises (associated with bad management at micro level). The third type - epidemic micro crises - are seen to be more prevalent in developing countries (Honohan, 2000). We find this typology quite useful and we believe that to understand the banking system in Kenya, one needs to carry out a microanalysis for the sector. However, there is a need to move beyond

⁴⁷ Literature on the East Asian financial crises with specific reference to corporate governance is discussed in Chapter 7.

⁴⁸ We believe that the predictive ability of the model is also highly questionable as it does not predict a crisis or predicts a crisis 3 years before in 39% of the cases.

⁴⁹ Their sample includes Kenya where episodes of systemic crises are recorded for 1985-89, 1992 and 1993-95.

this typology. As we argue in Chapter 6, the segmented nature of the banking sector means that management failures will be different for different segments of the banking sector.

2.5 Concluding Remarks

This chapter discussed the debates on whether finance leads to growth, the debates surrounding the design of the financial system and the sources of financial fragility. The chapter showed that there is consensus on how finance can lead of the growth and the function that finance and banks should fulfill. However, the chapter showed that there is very little consensus on the circumstances and institutional characteristics that assist or impede finance to fulfill its functions.

At this stage it would be useful to look at the work of Gerschenkron. Though Gerschenkron is often cited as a proponent of the finance for growth school, his argument is a lot more nuanced and emphasizes the diversity of the development process and the institutional arrangements that emerge (Serieux, 2008; Tobin, 2008).⁵⁰ Gerschenkron made a distinction between three types of countries in terms of their ability to mobilize capital.⁵¹ In “advanced” countries typified by Britain during the 17th and 18th centuries, original capital accumulation and private wealth could easily be mobilized to finance enterprise growth without the need for banks. In contrast “moderately” backward countries such as Germany and France banks provided the long-term capital for industry to catch up with England.⁵² The tensions created by this backwardness led to institutional developments including the amalgamation of German banks which forced the cartelization of German industry (Gerschenkron, 1962 pp., 15). However, in the “third” category of “very backward” countries such as Russia where

⁵⁰ “It is the main proposition of this essay that in a number of important historical instances industrialization processes, when launched at length in a backward country, showed considerable differences, as compared with more advanced countries, not only with regard to the speed of development (the rate of industrial growth) but also with regard to the productive and organizational structures of industry which emerged from those processes (Gerschenkron, 1962 pp., 7).

⁵¹ In terms of methodology this can be linked to earlier arguments. In his analysis, Gerschenkron captures the diversity of economic development process in a manner that is not captured by econometric growth equations.

⁵² “A German bank, as the saying went, accompanied an industrial enterprise from cradle to grave, from establishment to liquidation throughout all the vicissitudes of its existence” (Gerschenkron, 1962 pp., 14).

“backwardness appear in such an accentuated form” (Gerschenkron, 1962 pp., 16) that “no banking system could conceivably succeed” (Gerschenkron, 1962 pp., 19). The circumstances required “special institutional factors designed to increase supply of capital to nascent industries” (Gerschenkron, 1962 pp., 354). In the case of Russia, state intervention was necessary to mobilize resources.

The data displayed in Chapter 1 shows that SSA can be placed in Gerschenkron’s third category. But an extremely complex problem arises - both the state led financial development and the market led financial development have not lead to financial deepening - yet, the need for long term finance for productive investment remains critical. It is hoped that this thesis with its focus on the experience of Kenyan banks with lending, deposit mobilization and corporate governance, will give insights into the institutional arrangements that constrain the banking sector in Kenya.

CHAPTER 3 – STUDIES ON FINANCE IN AFRICA

“A major irony of African development history is that the theories and models employed have largely come from outside the continent. No other region of the world has been so dominated by external ideas and models.”

Mkandawire and Soludo (1999 pp., vii)

“African Studies enjoys an increasingly close connection with bilateral and multilateral development co-operation, providing research and researchers (along with their own conceptual frameworks and concerns) to assist in defining and providing direction for aid and related policies. This is leading to unhealthy practices, whereby African research is ignored in the formulation of international policies towards the continent; while external Africanists assume the function of interpreting the world to Africa, and vice versa. This dynamic reinforces existing asymmetries in capacity and influence, especially given the crisis of higher education in most African countries. It also undermines Africa's research community, in particular the scope for cross-national and international exchange and the engagement in broader development debates, with the result that those social scientists who have not succumbed to the consultancy market or sought career opportunities elsewhere are encouraged to focus on narrow empirical studies.”

Olukoshi (2006 pp., 533)

3.1 Introduction

In Chapter 1, we laid out the main characteristics of the financial sector in SSA and showed that in general the formal financial sector in this region is shallow, inefficient and fragile. The major debates on the links between finance and development in the literature were discussed in Chapter 2. In light of these debates, this chapter considers the literature on the formal financial sector or banking in SSA that is attempting to understand the reasons for the shallowness, inefficiency and fragility.⁵³

In Section 3.2 we discuss the studies that discuss the link between finance and growth in SSA. Studies on the impact of financial liberalization in Africa are discussed in Section 3.3. Section 3.4 and Section 3.5 discuss studies on market structure and competition of

⁵³ As said in Chapter 1, banks form the key portion of the formal financial sector in SSA and these terms will be used interchangeably.

studies on efficiency of banks in SSA respectively. Section 3.6 discusses studies on excess liquidity in SSA banks while studies on banks failures are discussed in Section 3.7. Finally Section 3.8 discusses the few studies that attempt to understand how banks mobilize deposits in SSA with Section 3.9 providing concluding remarks to this chapter.

There is substantial literature on the financial sector in Africa. Heterodox economists established the importance of informal finance in the financial landscape in Africa (Aryeetey & Udy, 1997; Nissanke & Aryeetey, 1998; Wai, 1992). Following this, there has been significant research on informal finance - the segmentation between informal and formal finance, the role of microfinance institutions, and access to finance for poor - by both mainstream and heterodox economists. With specific reference to Kenya, some of the most interesting heterodox work in microfinance is by Susan Johnson and emphasizes the importance of social or 'real' factors affecting financial markets (Johnson, 2004a, 2004b, 2004c, 2005).

With reference to the formal financial sector or banking in SSA, Nissanke and Aryeetey (1998) was one of the first, and remains one of the key heterodox texts. The authors highlighted the extremely complex nature of the failure of liberalization in SSA and were one of the first to draw attention to the problem of excess liquidity of commercial banks in SSA. Following this, as the broad literature review below shows, the majority of the work done on formal financial sector and banking in Africa is from mainstream schools. This work is focussed on quantitative methods with very little attention paid to the structural and historical factors affecting the banking sector. The literature review also highlights that the majority of these studies do not consider the social or non-price factors that are essential to understanding the structural features of a banking system in SSA.

3.2 Studies on the Link between Finance and Growth in Africa

Chapter 2 discussed the debate between finance and growth in the literature. This debate has also been tested empirically with data from SSA and the Middle East and North Africa (MENA) regions, and these papers are discussed below.

In one of the early cross country studies of 32 SSA countries Ndebbio (2004) attempts to measure the link between finance and growth using two variables of financial

deepening – the first is ratio of M2 over GDP and the second is growth rate of per capita money balances.⁵⁴ He concludes that financial deepening positively affects per capita growth in output.⁵⁵ The author reaches this conclusion even though the coefficient associated with the ratio of M2 over GDP was insignificant:

“Fair enough... that of financial intermediation was insignificant. Both variables coefficients, however, had the right signs. This is *important for policy*”

Ndebbio (2004 pp., 16)⁵⁶

Drawing extremely strong conclusions from such weak quantitative data is highly problematic.

Ghirmay (2004), carries out a cross country study of 13 African countries and concludes that there is a positive and causal relationship between financial development and economic growth.⁵⁷ The author himself acknowledges that while there is evidence for causality in 8 out of 13 countries, there is apparent reverse causality in 9 countries in the sample. The conclusion is based on evidence of bi-directional causality in just 6 countries in the sample, and is therefore highly questionable.

Akinboade (2000) studied the relationship between financial deepening and growth in Tanzania using total bank deposits to measure financial deepening. The paper finds that in line with McKinnon-Shaw hypothesis, removal of interest rate restrictions and positive real interest rates led an to increase in bank deposits. However the regression results for the relationship between financial deepening and growth were more mixed. The relationship is negative and significant during the period of financial liberalization (1982- 1996) but insignificant during the period of financial repression (1966-1981).

⁵⁴ The Ndebbio study and the majority of the studies discussed in this chapter by African economists have been sponsored by the AERC (African Economic Research Consortium) see www.aercafrica.org.

⁵⁵ The author uses ordinary least squares (OLS) regression and covers the period 1980-1989, using decade averages for the variables.

⁵⁶ Emphasis added.

⁵⁷ The author uses vector autoregression (VAR) framework. Economic growth is measured in terms of increase in real GDP and financial development is measured in terms of level of credit to the private sector by financial intermediaries.

Two studies of the link between finance and growth in the MENA region also give conflicting results. An analysis of eleven MENA countries from 1980 to 2001, shows that besides the variable credit to the public sector, no other indicators of financial development have a significant impact on growth (Al-Zubi, Al-Rjoub, & Abu-Mhareb, 2006).⁵⁸ Another study of six MENA countries (Algeria, Egypt, Israel, Morocco, Syria and Tunisia) uses four different measures of financial deepening for the period 1963-1993 and finds a strong unidirectional relationship between financial development and growth in five of the six countries (Abu-Bader & Abu-Qarn, 2008a).⁵⁹ In the sixth country Israel, the country with most developed financial system, they do find not evidence of the impact of financial deepening on growth and only weak evidence of the impact of growth on financial deepening. They argue that their results “are in line with earlier studies that found stronger support for the supply-leading hypothesis in developing countries and the demand following hypothesis in developed countries” (Abu-Bader & Abu-Qarn, 2008a). The conviction with which they present their results is particularly surprising considering that the same authors, in another paper, found evidence for bi-directional causality between finance and growth for Egypt (Abu-Bader & Abu-Qarn, 2008b).

All the papers show that empirically it is very difficult to prove a strong link between finance and growth and results often depend on the model specification, countries in the sample, sample period and definitions of financial deepening variables. Furthermore, the methodological arguments against econometric analysis of Kenny and Williams (2001) and (2002), that were discussed in Chapter 2, also apply to these studies.

Marianne Bertrand who reviewed the finance and development research carried out by the World Bank for the ‘Deaton Report’ has also raised similar concerns. While recognizing that the World Bank research agenda in this area can be termed a success in terms of the number of publications accepted in top finance and economics journals she questions the over-reliance on cross country regressions. It is worth quoting her remarks in full in particular as the research agenda in SSA largely follows this same pattern:

⁵⁸ They follow the model of Levine (1997).

⁵⁹ The four measures of financial deepening used are M2 to GDP, M2 minus currency to GDP, private sector credit to GDP, and credit issued to nonfinancial private firms to total domestic credit

“While (and maybe because) fundamental, these questions are also extremely difficult to answer convincingly. In particular, the cross-country approach that is adopted in much of the research I have reviewed suffers from serious limitations. While this research approach has established clear correlation patterns between many of the key variables of interest, the policy takeaways of this research are often quite limited due to obvious interpretational issues. Also, this research approach is often too “black-boxy” to provide practical guidelines for those in charge of policy design and implementation. While I am certainly not advocating abandoning the cross-country research methodology, I was nevertheless surprised by how prevalent this research methodology was in the various projects I reviewed. In particular, I found detailed case studies, where one can delve deeper into the specific experiences of a given country (or a given financial institution within a country), remarkably scarce. My view prior to going into this evaluation is that Bank researchers had a strong comparative advantage in such case studies compared to researchers at academic institutions, not only given the huge amount of field experience within the Bank but also given the many contacts the Bank has with financial institutions and financial agencies around the world. I was surprised not to see this comparative advantage more strongly reflected in the Bank research”

Deaton *et al* (2006 pp., 111)

All five of the specific studies discussed above, are by mainstream economists. Even when the expected positive relationship between finance and growth is not found in the data, policy conclusions are drawn pointing towards increased liberalization. Ndebbio (2004) argues “this apparently less than satisfactory performance of the financial intermediation variable is due basically to the shallow finance and the absence of well functioning capital markets in most SSA countries” (pp., 17). Akinboade (2000) attribute the mixed results to the “erstwhile socialist orientation” (pp., 948) of banking in Tanzania. Al-Zubi et al. (2006) state that “financial sectors are still underdeveloped and need more efforts to be able to exert its functions effectively in the Arab countries”. They are based on a closed system analysis with little recognition that there may be important factors affecting these relationships that cannot be captured by the available data.

3.3 Studies on the Impact of Financial Liberalization in Africa

As discussed in Chapter 2, in the ‘financial repression’ literature, it is advocated that financial liberalization would end credit rationing by the state and allow other investors to borrow from financial intermediaries (McKinnon, 1973; Shaw, 1973). This argument formed the rationale for financial liberalization - which was undertaken in most African countries in the 1980s and early 1990s as part of the structural adjustment policies advocated by the World Bank and the IMF. It was expected that that liberalization would increase financial deepening, private savings, investment and in turn growth.

There is a general recognition in the literature that financial sector reforms did not generate the fruits expected in terms of an increase in savings and investment, improvement in financial sector intermediation and reduction in interest rate spreads (Brownbridge & Harvey, 1998; Mkandawire, 1999; Ndung'u & Ngugi, 1999; Ngugi & Kabubo, 1998; Nissanke & Aryeetey, 1998; Adedoyin Soyibo, 1997; World Bank, 1994). The main mechanism through which financial liberalization was going to impact resource mobilization was through impact on savings. In an early study on a cross section of African countries it was found that the effect of real interest rates on savings is weak or non-existent (Mwega 1990).

There is also a recognition that financial liberalization was accompanied with increased instability and higher incidence of bank insolvencies (Brownbridge, 1998a; Brownbridge & Harvey, 1998; Soyibo & Adekanye, 1992). Experience from African countries suggests that credit to the private sector did not grow after liberalization and in fact banks shifted their portfolios towards government stocks (Nissanke & Aryeetey, 1998; Serieux, 2008). Instead of lending long term banks maintained highly liquid portfolios and there was a high incidence of non-performing loans (Aryeetey, Hettice, Nissanke, & Steel, 1997; Chirwa, 2001; Nissanke & Aryeetey, 1998).

However, there is still significant debate as to why the reforms did not bear fruit. At a theoretical level, working from within a new institutional framework, Joseph Stiglitz has emphasized that credit rationing in the credit markets is not merely the result of ‘financial repression’, but is rather inherent to any financial market due to pervasive information asymmetries and incomplete markets (Stiglitz, 1993; Stiglitz & Weiss, 1981). Furthermore, the increase in interest rates following liberalization tends to worsen the

risk composition of banks' loans portfolios, aggravating the problems of adverse selection and moral hazard (Stiglitz, Helmann, & Murdoch, 2000).

In general, mainstream authors have argued that liberalization failed due to the incompleteness of reforms, poor sequencing and lack of government will (Reinhart & Tokatlidis, 2003; World Bank, 1994). With specific reference to banks, it was observed that following liberalization, banks moved in two dramatically opposite directions – they either avoided all but the lowest risk lending or they exhibited a reckless expansion of lending even to insolvent clients (Caprio, Atiyas, & Hanson, 1994). Both these reactions can lead to an increase in fragility of banks' balance sheets. Following this observation, it is argued that it is necessary that certain 'initial conditions' must be met before financial sector reform is embarked upon and these include – first, reasonably stable macroeconomic conditions; second, sound financial conditions of banks and their borrowers; third, attainment by bank personnel of basic minimum financial skills; and fourth checks and balances to minimize collusion amongst banks (Caprio et al., 1994). Therefore there is a firm acknowledgement of the need to build 'institutional capacity' before undertaking reforms (Caprio, 1994).

“In designing reform programs, African governments and external donors have sometimes placed too much faith in quick fixes. Reform programs overestimated the benefits of restructuring balances sheets and recapitalizing banks – and underestimated the time it takes to improve financial infrastructure in an environment where the main borrowers (the government and the public enterprises) are financially distressed and institutionally weak’

World Bank (1994 pp., 204).

The recognition of the importance of institutional factors is useful; however, there is a methodological issue with this sort of analysis as it reduces historical development to a small set of 'initial conditions.' It is also hypocritical to talk about 'poor sequencing' after the World Bank had already pursued the reform process of liberalization in most SSA countries. Liberalization was based on the explicit principal that once the prices (in

this case interest rates) were set free, market forces would ensure that savings were mobilized.⁶⁰

At this stage it would be useful to remember Gerschenkron who questioned the notion of prerequisites for industrial development “...there is not general set of prerequisites valid for all times and climes....each case must be studied independently” (Gerschenkron, 1962 pp.,46).⁶¹

In carrying out a review of articles that attempt to understand why financial liberalization did not achieve the desired results in SSA, it is argued “A common theme that runs through the papers in this supplement is the *peculiarity* of African economies and institutions....A low quality of institutions appears to have constituted a primary culprit in this limited success” (Fosu, Kimenyi, & Ndung'u, 2003).⁶² In methodological terms, the idea of institutions ‘peculiar’ to Africa implies a bias towards a monolithic idea of what ‘good’ institutions are. A review of institutional developments in Europe and Asia reveals great institutional diversity yet this is not reflected in work on African institutions. We concur with Olukoshi (2006) who charged that:

“Contemporary processes on the African continent are frequently considered as being subject to a unilinear evolutionism, replicating an earlier epoch in the history of Europe and the solutions to the challenges associated with such processes also, naturally, replicating the ‘models’ that had been employed by Europe. Scholars ignore the fact that every facet of the development history of Europe and North America is under permanent debate, and revision makes it difficult to capture past experiences as historical truths that have been settled once and for all. Instead, in the culture of scholarship by analogy, many Africanists are tempted to present the histories of Europe and America in a frozen form that is bereft of all contradictions. In the worst cases, the result is an attempt by Africanists to

⁶⁰ As a corollary, it should be remembered that in the application of liberalization reforms to ex-Communist countries, there was an explicit argument and expectation by both Western experts and Soviet academics that market institutions would spring up as soon a central planning was abolished (Dow et al., 2008).

⁶¹ Gerschenkron was referring specifically to the notion of ‘original capital accumulation’ but the insight is useful to remember in this case.

⁶² Emphasis added.

read Africa through a simplistic, one-sided, incomplete, and ill-digested history of Europe and America”

Olukoshi (2006 pp., 541)

Heterodox economists have emphasized that the reasons financial liberalization did not lead to the improvement expected are extremely complicated. In countries such as Ghana and Malawi, reform was more gradual, yet there have been few positive changes in financial indicators and outcomes are similar to countries where reform was much more rapid (Nissanke, 2001). They have emphasized the fragmentation and segmentation of markets and the fact that liberalization was carried out as a response to severe economic crises and acute macroeconomic instability (Aryeetey, Senbet, & Udy, 1997; Brownbridge & Harvey, 1998; Nissanke & Aryeetey, 1998; A Soyibo, 1997).

3.4 Studies on Market Structure and Competition in Banks in Africa

Neoclassical economics begins with the assumption that increased competition will lead to lower costs and enhanced efficiency in the financial market. However there is now a growing recognition, even in the mainstream literature, that assuming “competition is unambiguously good in banking is naïve” (Claessens & Laeven, 2003 pp., 4). It is argued that the information intensive nature of banking implies that banking is naturally less competitive than other sectors (Caprio & Levine, 2002). Oligopolistic competition may lead to higher intermediation costs and higher spreads and inefficiency or may lead to more efficient market through the exploitation of economies of scale (Buchs & Mathisen, 2005).

Not only are the links between competition and efficiency complex, the links between competition, efficiency and stability are just beginning to be explored (Allen & Gale, 2004; Beck, Demirgüç-Kunt, & Levine, 2006). A certain degree of market power may be beneficial in banking as it can moderate banks’ risk taking incentives. A bank with more market power, franchise value and higher profits has more to lose if it takes an excessively risk policy (Vives, 2001). In the same vein other authors have argued that the reduction in franchise value and rents led to an increase in bank failures in the 1980s (Keeley, 1990; Stiglitz et al., 2000).

There is no doubt that the banking systems in SSA are highly concentrated as shown in Table 2.

Table 2: Structural Features of Banking Systems in SSA

	Kenya	Ghana	Nigeria	South Africa	Tz.	Ug.	Zambia	SSA average
Number of Banks	53	17	51	60	9	15	16	--
Bank concentration (3 banks)	45.6 ⁶³	55.0	86.5	77.0	45.8	70.0	81.9	81.0

Source: Ncube (2007)

Despite recent recognition in the literature that “different countries may have different optimal level of competition intensity” (Vives, 2001), empirical work done in Africa continues to follow a Structure-Conduct-Performance (S-C-P) paradigm where it is assumed that the low levels of competition is the main contributor of the poor performance of African banking. More crucially they all assume that high levels of concentration automatically result in lower competition.

For example, in a survey of the financial sector in Africa, using data from 13 African countries, Ncube (2007) argues that the oligopolistic nature of the banking market is a key reason for the high interest rate spreads.

Chirwa (2001), in an extensive study of the Malawian banking industry, also carries out an S-C-P hypothesis by analyzing the determinants of profitability. He finds that support for collusion in the Malawian banking industry as market concentration has a positive and significant impact on profitability.⁶⁴ He argues that competition exists only on the fringes – with 9 banks competing for 25% of the market while 2 (government-owned) banks control 75% of the market. This leads to a policy conclusion that there is a need to privatize government owned banks to encourage competition. Without going

⁶³ This figure is based on the author’s own calculations.

⁶⁴ In the case of Malawi interest rates were controlled and the main source of profits was fee income (Chirwa 2001).

into the extensive debate on the merits of privatization here, it is useful to note that in other African countries privatization has not reduced the domination of a few strong banks (Ngugi & Kabubo, 1998).

Industrial organization literature has developed to show that competition is not only determined by concentration and market structure indicators alone, but that contestability is important (Baumol, Panzar, & Willig, 1982; Besanko & Thakor, 1992).⁶⁵ Empirically there have been a lot of studies conducted to measure competition, now defined in terms of contestability generally following the seminal work by Panzar and Rosse (1987).

Panzar and Rosse model investigates the extent to which a change in factor input prices is reflected in (equilibrium) revenues earned by a specific bank. The model provides a measure – the H statistic as a measure of the degree of competition. Table 3 below explains the interpretative value of the H statistic.

Table 3: Interpretation of H Value

Value of H	Implied Market Structure
$H \leq 0$	Monopoly, colluding oligopoly
$0 < H < 1$	Monopolistic competition
$H = 1$	Perfect competition, natural monopoly in perfectly contestable market

Source: Claessens and Laeven (2003)

Claessens and Laeven (2003) use this model to estimate the degree of competitiveness in a cross section of 50 developed and developing countries for the period 1994 – 2001. Buchs and Mathisen (2005) also apply the Panzar and Rosse model to estimate the H statistic for Ghana for the same period. A selection of the results are summarized in the table below.

⁶⁵ Competitive outcomes are possible in concentrated systems and collusive actions can be sustained even in the presence of many firms. Therefore, it is the threat of entry, contestability that is more important.

Table 4: H Statistic for Different Countries / Regions

Country	Period	<i>H</i> – Statistic
Kenya	1994-2001	0.58
Ghana	1998-2003	0.56
Nigeria	1994-2001	0.67
South Africa	1994-2001	0.85
North America (median)	1994-2001	0.67
South America (median)	1994-2001	0.73
East Asia (median)	1994-2001	0.67
South Asia (median)	1994-2001	0.53
Western Europe (median)	1994-2001	0.67
Eastern Europe (median)	1994-2001	0.68

Source: Buchs and Mathisen (2005) and Claessens and Laeven (2003)

It can be seen from the above table that an *H* statistic of between zero and one seems to be the ‘default’ result of applying this methodology and therefore the usefulness of this model to establish the level of competitiveness is highly questionable.⁶⁶ In banking in particular, full monopoly or perfect competition are unlikely. Furthermore, the model is based on several restrictive assumptions including that banks are operating in (long run) equilibrium.

Some authors who use this model do recognize this problem. For example Buchs and Mathisen (2005) state “what constitutes equilibrium in the banking sector remains elusive” (p 15) and “cross-country comparisons should be treated with caution”(p. 17).⁶⁷

⁶⁶ For example Buchs and Mathisen (2005) find that only significant result of their empirical work is that bank profits are highly correlated to the treasury bill rate and “banking sector and the government are trapped in a co-dependency scheme” (p 20)

⁶⁷ Buchs and Mathisen (2005) note that the *H* statistic implies Ghana is only slightly less competitive than Nigeria, yet it is known that Nigeria has significantly lower spreads than Ghana. Furthermore, *H*- statistic

Surprisingly, they justify continuing to use this model by stating that they are “following existing literature” (p 16).

However, many authors do not seem to recognize the limitations of this methodology. Mugume (2006) uses the Panzar and Rosee methodology to analyze the competitiveness of the Ugandan banking sector from 1995 to 2005 and again finds H statistic with a value of 0.28 on average for the entire period, 0.40 for the 2000-2005 period and 0.31 for the 1995-1999. He argues that this displays that the Ugandan banking sector is characterised by monopolistic competition with improved competition in the later period, due to “cleaning up of the sector” (Mugume, 2006 pp., 39). The H-statistic calculated is used as a measure of competition and regressed against concentration. The author argues that concentration negatively affects competition. However, concentration did not change dramatically in the period under consideration and there is little specific analysis as to why competition improved during the period.

Musonda (2008) uses the Panzar and Rosee methodology to analyze the competitiveness of the Zambian banking sector from 1998 to 2006. Table 5 below summarizes his results.

Table 5: Summary of H Statistic for Zambia from Musonda (2008)

	<i>H – Statistic</i>
Total Revenue (all banks)	0.711
Interest Revenue (all banks)	0.721
Foreign Banks (total income)	0.678
Local Banks (total income)	0.594
Foreign Banks (interest income)	0.64
Local Banks (interest income)	0.654
Large Banks (total income)	0.592

calculated by Claessens and Laeven (2005) for USA is 0.41 (p. 30 table 2) – the lowest in their sample. Their results contradict Shaffer (1989).

	<i>H – Statistic</i>
Small Banks (total income)	0.656
Large Banks (interest income)	0.656
Small Banks (interest income)	0.667

As the 5 largest banks in Zambia control over 80% of the industry, concentration ratios would imply that the industry is oligopolistic (Musonda, 2008). However, using the Panzar-Rosse model, the author argues that “key findings of the study are that Zambian banks earned their income under conditions of monopolistic competition. The *H*-statistic derived from the interest income specification is greater than that obtained with total income suggesting that commercial banks still regard traditional banking activities as important” (Musonda, 2008 pp., 42). The author’s bias towards foreign banks is also evident, as it is argued “Estimates for bank ownership indicate that foreign banks compete more intensely than domestic banks, supporting evidence from previous studies” (Musonda, 2008 pp., 42). This is despite the fact that the authors own data shows a rather mixed picture - while competition is higher amongst foreign banks for total income, it is lower when looking at interest income. In the introduction, the author highlights that the Bank of Zambia believes that the dominance of foreign banks is a problem for increasing credit in the market (Bank of Zambia, 2004). Yet, the author does not address this question in light of the results of his model. The author is also surprised that there is higher competition amongst small banks than large banks and argues that large banks have a higher regulatory burden.

It can be argued that while this paper is sophisticated in its application of econometric and panel data analysis, it reflects a lack of interest in of the exact nature of competition in the Zambian banking market, in particular the social and historical factors that shape the reputation of banks and the impact of this on competition between banks.

It is more useful to assess the exact nature of competition and whether an increase in competition is associated with improvements in performance or not. Maimbo (2002) carries out this sort of analysis in an interesting study that links competition issues to bank failures in Zambia. The author highlights that besides monitoring CAMELS financial ratios, the analysis of other factors such as the business strategies of local

banks - for example over reliance on cost-based competition would have revealed weakness in banks that later failed (Maimbo, 2002).⁶⁸

3.5 Studies on the Efficiency of Banks in Africa

Another recent trend in the literature has been to estimate the efficiency of banks in SSA. This follows the trend in mainstream literature where there are innumerable studies that attempt to move beyond a simple comparison of financial ratios to econometric modeling measuring the efficiency of financial institutions using frontier analysis. In this section we will discuss briefly the theory of frontier analysis followed by the application of this type of analysis to banking in SSA. The main aim of this section is to show that this form of analysis is becoming dominant in the research on banking in SSA and is based on a false sense of rigor. Even if this sort of methodology is accepted, the papers discussed here can be criticized on their own terms. We will also discuss more serious methodological issues with this type of analysis and show that they do not generate a deeper understanding of the banking system in SSA.

Frontier analysis involves the establishment of an efficient benchmark, or frontier, and then the distance of a firm from the frontier measures the extent of the firm's inefficiency. The frontier is usually established in terms of technical or cost efficiency (maximum output for given input) or allocative efficiency (given output for minimum input). Hasan (2005) provides a good critical summary of the theoretical underpinnings of these studies and highlights that theoretically allocative and technical efficiency measure different concepts, even though they are used interchangeably in the empirical literature.

The majority of empirical studies follow two stages. In the first stage, (in)efficiency from the frontier is measured. The two most common methods of measuring efficiency are:- parametric stochastic frontier analysis (SFA) or a non-parametric development envelope analysis (DEA). The models of the output and input functions have become highly sophisticated deploying translog or flexible functional forms in preference to the more traditional Cobb-Douglass production function. It should be noted, that this frontier analysis can be applied across a variety of industries. In studies of banking, there are no

⁶⁸ CAMELs is an acronym that stands for financial ratios of Capital, Assets, Management, Earnings and Liquidity. See brief discussion on CAMELs issues in Chapter 1.

consistent measures of input or output used to define the frontier. Input measures used include labor costs, physical capital costs and costs of deposits or total value of deposits. Measures of output used include the total value of loans, total assets, income from loans or off balance sheet variables. Following Fare, Grosskopf et al (1994), the efficiency results are sometimes decomposed using a Malmquist decomposition into technical efficiency and technological change, with the former further decomposed into a pure efficiency change and scale efficiency change, to understand changes over time or between companies or between regions.

In the second stage of the analysis the calculated measures of (in)efficiency are then used as a dependent variable in a model with selection of determinants of (in)efficiency as independent variables. Berger and Humphrey (1997) provide a summary of 121 studies in 21 countries based on these efficiency models, and though they are generally proponents of this method, they raise several limitations of the studies some of which will be discussed below.

Here we discuss two such studies in SSA - Egesa (2006) who attempts to understand the efficiency of banks in Uganda and Aikaeli (2008) whose analysis looks at banks in Tanzania.

Reforms of the financial sector in Uganda started in 1992 and Egesa (2006) measures the changes in efficiency or productivity from 1993 – 2005 for 11 banks.⁶⁹ Productivity or efficiency is measured using non-parametric Malmquist Index. At an aggregate level, the author finds an overall decline in productivity from 1993 – 2005. However, the steep decline in productivity after 1993, is slightly reversed by the increase in productivity from 2002 (Egesa, 2006). Results for productivity change at an individual bank level are shown in Table 6.

⁶⁹ The total number of commercial banks in Uganda was 15 in 1993, which increased post liberalization to 20 banks in 2000 but then decreased to 15 in 2004 (Egesa, 2006)

Table 6: Bank and Ownership Efficiency Change Measures in Uganda 1993 – 2005

Bank	Ownership	Technical Efficiency change index	Technological change index	Pure efficiency change index	Scale efficiency change index	Total factor productivity change index
1	Foreign	0.997	1.009	0.996	1.001	1.006
2	Foreign	1.000	1.013	1.000	1.000	1.013
3	Foreign	1.000	0.982	1.000	1.000	0.982
4	Local	0.985	1.021	0.992	0.993	1.006
5	Local	1.000	0.974	1.000	1.000	0.974
6	Foreign	1.000	0.999	1.000	1.000	0.999
7	Foreign	0.994	1.011	0.996	0.999	1.005
8	Local	1.000	0.984	1.000	1.000	0.984
9	Foreign	1.000	0.975	1.000	1.000	0.975
10	Foreign	1.000	1.025	1.000	1.000	1.025
11	Foreign	0.994	0.980	0.998	0.996	0.974
Mean		0.997	0.997	0.998	0.999	0.995

Source: Egesa (2006)

The author argues that this shows “improvements among four foreign banks and one local bank over the entire period, explained entirely by technological improvements. There were no changes in pure and scale efficiency for the majority of banks. However, three foreign banks had a decline in pure efficiency compared to one local bank. The same local bank also had a decline in scale efficiency although the gains in technological efficiency were more than enough to offset the decline in efficiency change” (Egesa, 2006 pp., 23). Besides giving an explanation of the results, this analysis does not give us any meaningful understanding of the changes in efficiency banking system in Uganda from 1993 – 2005, including what sort of technological improvements were taking place.

In the second stage, the author then assesses the determinants of productivity using a two way error components model. The results are summarized in Table 7.⁷⁰

⁷⁰ The author gives results for 3 different estimates, a random period effects model, a fixed cross section and random period effects model and a fixed cross section and period effects. The results quoted here are for the third - fixed cross section and period effects model which has the highest adjusted R-squared.

Table 7: Regression Results of the Determinants of Productivity in Uganda

Variable	Measured By	Expected Sign	Hypothesis	Empirical Results
Size	Assets of bank / Total assets of banks in industry	+ve	Economies of scale, large size → high productivity	-ve but not significant at 10% level
Capital Adequacy	Core Capital / Risk Weighted Assets	+ve	high capital → high productivity	-ve
Asset Quality	Non-performing Loans / Total Loans	-ve	High non performing loans → low productivity	+ve but not significant
Shareholder Stake in Bank	Equity / Total Assets	+ve	High shareholder stake, reduces agency problems → high productivity	+ve
Liquidity	Total Assets / Total Deposits	-ve	High (excess) liquidity → low productivity	+ve
Return on Assets	Return on Assets	+ve	Higher profits lead to increased productivity	+ve
Adjusted R-squared				0.0652

Source: Egesa (2006 pp., 26)

It should be noted that very little thought appears to have been put into deciding the independent variables in particular return on assets. It is tautological to use return on assets as an independent variable. This variable is an output that is used to calculate the efficiency frontier in the first stage. Therefore, it is not surprising that the most significant variable in the model is return on assets. Furthermore, while econometric model is sophisticated, there is little analysis as to why the results of the analysis are in most cases opposite as to what would be expected.⁷¹

The second study by Aikaeli (2008) is based on the banking system in Tanzania using data from 1998 – 2004.⁷² The author carries out non-parametric DEA, non-parametric

⁷¹ With a t value of 4.09, it is significant even at the 0.1% level.

⁷² This paper is based on research done by the author during his PhD thesis which was awarded in 2006 by University of Dar-es-Salam and sponsored by the AERC's Collaborative PhD Programme.

Malmquist indices of efficiency change and parametric SFA.⁷³ The paper is useful as it makes some attempt to understand the segmentation in the market as the efficiency indexes are calculated for different segments.⁷⁴ Results for productivity change using the non-parametric Malmquist index at the segment level are shown in Table 8.

Table 8: Bank and ownership efficiency change measures in Tanzania 1998 – 2005

Group	Technical Efficiency change index	Technological change index	Pure efficiency change index	Scale efficiency change index	Total factor productivity change index
Large Private Owned	1.000	1.131	1.000	1.000	1.131
Large Foreign Owned	1.000	1.056	1.000	1.000	1.056
Small Private Owned	1.002	0.992	1.000	1.002	0.994
Mean	1.001	1.058	1.000	1.001	1.059

Source: Aikaeli (2008)

The results indicate that the largest change in productivity occurred amongst the large private owned banks, and that overall productivity in the small private owned banks decreased. However, it should be noted that this finding contradicts the results of the other 2 models – in the DEA, the productivity of small banks increased and according to the SFA analysis, the efficiency of small banks increased. Again, the author makes no attempt to understand why the different models give differing results.

⁷³ It is not clear from the study the number of banks that are included in the sample.

⁷⁴ It is not clear why for the non-parametric approaches the banks are divided into three groups – large banks, international banks and small banks, yet for the parametric they are divided only into two groups - large banks and small banks.

In the second part of the analysis, the indexes of inefficiency calculated through the parametric SFA model are regressed against possible determinants of inefficiency using a Tobit model. The results of the analysis are summarized in Table 9.

Table 9: Regression Results of the Determinants of Bank (In)efficiency in Tanzania

Variable	Measured By	Expected Sign	Hypothesis	Empirical Results
Size	Assets of bank / Total assets of banks in industry	-ve	Economies of scale - Small size → high inefficiency	+ve and significant
Capital Adequacy	Spending on capital goods (fixed assets, office fittings)/non-tax expenses	- ve	Low capital → high inefficiency	-ve and significant
Assets quality	Non-performing Loans / Total Loans	+ve	Low asset quality → high inefficiency	Not significant
Labour compensation	Salaries and Remuneration / Other Non-Tax Expenses	-ve	Low compensation → high inefficiency	-ve and significant
Excess Liquidity	Liquidity – Statutory Liquidity	+ve	High (excess) liquidity → high inefficiency	+ve and significant
Pseudo R squared				-0.1634

Source: Aikaeli (2006 pp. 101, 135)

The analysis has serious flaws even on its own terms. The use by Aikaeli of expenditure on capital goods as the measure of capital adequacy shows a clear lack of understanding of a bank's balance sheet. Capital in this context is the equity of the shareholders and clearly very different from expenditure on capital goods that is used for industry.⁷⁵ Again there is no clear attempt to understand why the size variable gives the opposite result to the one expected, or why asset quality, which according to theory should be a significant determinant of efficiency, is not significant.

⁷⁵ Refer to Chapter 2 for a summary discussion of a simplified version of a bank's balance sheet.

Both these papers are from the mainstream, but it can be seen that they do not meet the standards set by good mainstream economists. They do not acknowledge some of the limitations of efficiency models highlighted by even the strongest proponents of this method of analysis. Berger, Hunter et al. (1993) highlight that the key difference between the parametric SFA and the non-parametric DEA is that they maintain different assumptions about the probability distribution of banking data. They caution that there is no simple rule for determining the true distribution of banking data, yet the choice of measurement method strongly affects the measurement of inefficiency and therefore extreme care needs to be taken when deciding the method that should be used (A Berger et al., 1993). Neither of the papers discussed above make any attempt to understand how this limitation would impact on their analysis. Egesa (2006) uses a non-parametric model on the grounds that a parametric model requires large data sets which are not available for these countries. However, if the banking process in these specific countries is characterised largely by stochastic elements, then the non-parametric approach may not be appropriate (Hasan, 2005). Based on the discussions by Berger, Hunter et al. (1993) it should not come as a surprise that when Aikaeli (2006) carries out all three methods - non-parametric DEA, non-parametric Malmquist decomposition and a parametric SFA, he gets conflicting results (as discussed above). What is surprising is there is no attempt made to understand why each of the method gives different results in this case.

Therefore, even if we view these papers from a mainstream perspective, they can be criticized as they draw strong conclusions on extremely weak basis. Using the DEA model, the average efficiency of all banks during the period is Tanzania is 97.4% and therefore it is concluded that:

“The *remarkable* comment from the findings of this study is that efficiency status of commercial banks in Tanzania is *not disappointing* to the financial sector reforms because the *scores* turned out to be fairly high”

Aikaeli (2008 pp., 20).⁷⁶

This conclusion is based on a comparison with efficiency scores of twenty five other studies based on frontier models in various countries where even developed countries such as the UK scores 83.3 and Italy scores 80 (Aikaeli, 2006 , Appendix 9). This sort of

⁷⁶ Emphasis added.

simple comparative analysis is not justified considering that each study or country will have had a different input / output combination used to measure the frontier. Even mainstream economists have recognized that cross country comparisons of even simple banking ratios is fraught with difficulties due to differences in product mix, capital structures, accounting conventions and inflation (Vittas, 1991). Aikaeli's conclusion is also startling in light of all the problems of the Tanzanian banking system, including regionally low levels of credit to the private sector and high margins, that the author highlights in the introduction to his thesis (Aikaeli, 2006). Based on the negative co-efficient between size and productivity Egesa (2006) concludes:

“...there is also a need to relax entry requirements by way of relaxing the capital requirements. The findings on the determinants of productivity suggest that there is room for increased productivity if rather than blocking entry by way of higher requirements; more pro-competition measures are pursued”

Egesa (2006 pp., 29).

It is astonishing how this conclusion can be reached when in all three model specifications, bank size is not a significantly associated with productivity.⁷⁷

In heterodox terms, six methodological criticisms can be raised against this type of frontier analysis. First, in the second stage of analysis, there are innumerable factors that can influence efficiency: including agency problems; regulation issues; legal issues; organizational issues; scale and scope issues; and CAMELs issues. The tendency in the analysis is to use a ‘pick- and-mix’ approach to choose the independent variables as the determinants of efficiency.⁷⁸

Second, the link between bank efficiency and intermediation is not necessarily direct. It is argued:

“If these institutions are becoming more efficient, then we might expect improved profitability, greater amounts of funds intermediated, better

⁷⁷ Again there is a tendency to make simple conclusions on size and competition that were discussed above in Section 3.4.

⁷⁸ Refer to the general criticisms of this type of analysis in Chapter 2 with reference to growth equations.

prices and service quality for consumers, and greater safety and soundness if some efficiency savings are applied toward improving capital buffers...”

Berger et al (1993).

While efficiency may lead to more profitable institutions, it is a leap of faith to assume that technical or allocative efficiency will automatically lead to or lower prices for clients, or higher lending levels or increased safety of institutions.

Third, due to specialization of banks, it is problematic to assume that all banks produce a homogenous output and operate on the same efficiency frontier (dos Santos, 2007). Therefore the comparability of efficiency of institutions with even one banking sector is problematic. Fourth, the nature of a lending decision means that there will be several cases in which a bank rejects applications that do not meet its criteria particularly in terms of repayment. This decision is likely to improve the efficiency of the bank and reduce future non-performing loans, yet in the above analysis this would imply use of an ‘input’ without any corresponding increase in ‘output’ and therefore be measured as a reduction in efficiency (dos Santos, 2007). Fifth, this analysis does not capture non-price or social factors that are extremely important in the lending process in developing countries. Finally, and most crucially the analysis cannot account for the impact of segmentation of the market, which again means that it is unrealistic to assume that banks operate on a single efficiency frontier.⁷⁹ Therefore, these efficiency models cannot truly measure intermediation efficiency, which as discussed in Chapter 2, is the key function of banks.

3.6 Studies on the Excess Liquidity of Banks in Africa

One of the first studies to recognize and highlight the problem of excess liquidity of asset portfolios is Nisanke and Aryeetey (1998). From a regulatory point of view, excess liquidity is not a problem.⁸⁰ However in terms of the role of banks as

⁷⁹ In Chapter 6 we discuss the importance of social factors and the impact of segmentation in the lending process for the banking sector in Kenya.

⁸⁰ The Central Bank of Kenya does not view excess liquidity as a problem. In fact, banks are rated according to their liquidity. Therefore successive reports state “overall liquidity was strong as in the previous year. Thirty six institutions with a combined market share of 77% were rated strongly with only one bank with a market share of 5% was rated unsatisfactory” (Central Bank of Kenya, 2003 p. 23).

intermediaries excess liquidity presents an inability of banks to lend long term and voluntary credit rationing (Kagira & Kirkpatrick, 2001; Nissanke & Aryeetey, 1998). Before liberalization, excess liquidity was attributed to the high level of reserve requirements, set at between 40-80% by central banks in SSA. However, it has been shown that, post-liberalization excess liquidity remains a problem in SSA (Nissanke & Aryeetey, 1998) .

It has been suggested that the reasons for highly liquid asset portfolios are: the inability of banks to assess risks (Nissanke & Aryeetey, 1998), the high level of non-performing loans which make banks extremely cautious (Nissanke & Aryeetey, 1998), a ‘co-dependency syndrome’ between government and banks where banks invest heavily in government securities (Buchs & Mathisen, 2005); and the lack of acceptable and “bankable” loans applications (Honohan & Beck, 2007).

Aikaeli (2006) carries out an econometric study to understand the causes of excess liquidity in Tanzania from 1999 – 2004. In Tanzania, the statutory level of liquid assets is 20%, whereas during this period the average liquidity was 53% (Aikaeli, 2006). The results are summarized in Table 10.

Table 10: Causes of Excess Liquidity in Tanzania 1999 – 2004

Independent Variable	Hypothesis	Expected Sign of Correlation Coefficient	Results of Simple ADL model	Results of Error Corrected ADL model
Statutory reserve requirements	Increase in statutory reserves would lead to a reduction in excess liquidity as banks move liquid assets to reserves	-ve	-ve	3 rd and 4 th order lags are +ve and significant
Deposit holders’ cash preferences (measured as deviations from average cash held by banks)	Higher volatility of demand of cash leads to higher excess liquidity	+ve	+ve	Not included in the model presented

Independent Variable	Hypothesis	Expected Sign of Correlation Coefficient	Results of Simple ADL model	Results of Error Corrected ADL model
Illiquidity cost (measured as banks' borrowing rate)	Higher cost of borrowing from market leads to higher excess liquidity	+ve	+ve and but not significant	3 rd order lag is +ve and significant
Credit Risk (measured as deviation of returns of loans from average)	More following income stream from loans lead to higher excess liquidity	+ve	+ve but not significant	Unlagged variable is +ve and significant
Past excess liquidity				-ve and significant

Source: Aikaeli (2006) pp. 102, 151, 152

Several criticisms of this analysis can be raised. First, the simple ADL model is found to be co-integrated and the coefficients are not significant and therefore one can question the validity of the conclusions that the author draws from the results. Second, there is also little explanation as to why deposit holders' cash preferences is not included in the final 'parsimonious' specification of the ADL ECM model that is presented when theoretically this is thought to be a key determinant of excess liquidity. Third, the same author, when trying to understand the efficiency of the banking system, attempted to understand the difference between segments; yet this is not carried out for the analysis of liquidity. Fourth, it is not clear how from this analysis the author then concludes that high T-bill rates are leading to excess liquidity (pp. 167). Again, this has become typical of some of the work being carried out by young African economists where deeper understanding is clouded by a focus on the technicalities of econometric analysis.

3.7 Studies on Bank Failures in Africa

Authors that have specifically tackled the issue of bank failures in Africa are Daumont et al (2004), Kane and Rice (2001), Mpuga (2002) and Brownbridge (1998a).

Daumont et al (2004) is a cross country analysis of bank crises in Africa. They attempt to give overview of what went wrong with banking systems in SSA but, in their own words, “with a broad brush, illustrating major themes” (Daumont et al., 2004). They consider a list of factors that can contribute of financial system fragility and split them into three categories:-

- 1) operating environment (macro environment, exogenous shocks, lack of diversification of economy)
- 2) market structure (bank ownership, bank concentration, sources of bank funding)
- 3) banks’ conduct (corporate governance and lending practices).⁸¹

They then find evidence of the existence of these factors in different African countries. This thesis endeavours to understand how factors in the ‘third category’ - the real nature of banks’ conduct – internal governance and lending practices are affected by and in turn have an impact on the ‘second category’ – market structure and therefore overall fragility. However, as is ubiquitous in cross country analysis, Daumont et al (2004)’s understanding of banks’ conduct (the third category) is limited to a generalized commentary followed by a few examples, rather than analysis:

“*Credit appraisal* was generally *lax* as a systematic examination of the character, financial and economic track record, and prospective cash flow of borrowers often went missing. Security accepted as collateral too often was not verified for adequacy and authenticity before loans were granted, borrowers’ valuations were taken at face value, and title deeds were not verified. *Credit monitoring* was hampered by inadequate loan supervision practices. Usually lacking was the capacity to identify problem loans at an early stage and take measures to protect the bank and depositor funds as soon as a loan became past due. To begin with, banks did not properly document their loans. *For example*, in Côte d’Ivoire, loan contracts sometimes were not signed with borrowers. In Uganda, at the UCB,

⁸¹ In Chapter 6 we discuss the lending practices of banks in Kenya and in Chapter 8 we discuss corporate governance of banks in Kenya.

securities taken for delinquent loans could not be readily traced because the bank failed to establish firm repayment schedules and to monitor borrowers' performance against them"

Daumont et al (2004 pp., 36).

This 'pick and mix' analysis glosses over country specific complexities and the social and historical peculiarities that are essential to understanding the causes of bank failures.

Kane and Rice (2001) suggest that the two main causes of financial distress in Africa are (a) depositors' inability to monitor banks due to depositors' inability to obtain information on bank's condition and also act on this information (b) failure of regulation to counteract these weaknesses due to limited fiscal capacity and incentive conflicts.⁸² Both factors make it more likely for banks to experience runs based on false information. Therefore they form a testable hypothesis where the persistence of unresolved loan losses in a country's banking system is directly related to press restraint (PR) (used as a measure for lack of information) and corruption (C) (used as a measure for regulatory failure). Kane and Rice (2001) run a regression with number of years that a country has experienced financial stress as a dependent variable with GDP, PR and C as the independent variables. They find that only C has a significant coefficient. Not only are the proxies used for PR and C highly questionable but again the same criticisms applied above to Daumont et al (2004) can be leveled against this approach.

Mpuga (2002) analyzes the impact of new bank capital regulation that came into effect in December 1996 on local bank failures that occurred in 1998-99 in Uganda.⁸³ The author finds that: 1) there was no significant break or change in trend after the new regulation came into place 2) foreign banks performed well after new regulation came into place however 3) local banks "suffered more in terms of reduction in capital and increased risk" (p. 236) 4) capital regulation did not lead to the failure of local banks but

⁸² As will be discussed in Chapter 6, in reality, the ability of depositors to monitor banks can be seriously questioned.

⁸³ The model used is based on simultaneous equations of between bank capital, portfolio risk, and risk-based capital requirements using the two-stage least square (2LS) approach. Between 1998-99 four banks – International Credit Bank Ltd., Greenland Bank Ltd, The Co-operative Bank Ltd and Trust Bank Ltd were closed. The author classifies the first 3 as local banks and Trust Bank as a foreign bank. However Trust Bank was a subsidiary owned by the Kenyan Trust Bank, and therefore a local bank, if ownership is considered on an East African basis rather than solely Ugandan basis.

“failure seems to have been rooted more in internal problems” (p. 233). While this work is useful in highlighting that regulation can have differential impact on foreign and local banks, it does not go far enough in explaining why these differences occur. Furthermore, we argue that the author is asking the question from the wrong end. Instead of asking whether capital requirements led to bank failures, it would be more useful to ask – why did the introduction of capital requirements not prevent banks from failing?

Brownbridge (1998a) is a detailed analysis of bank failures in Kenya, Nigeria, Uganda and Zambia up to 1995. It uses the principle-agent framework and highlights factors that led to bank owners taking excessive risk with depositors’ money. As a starting point it recognizes the segmentation in African financial markets and makes the useful distinction between foreign-owned banks (foreign banks), government-owned bank (government banks) and locally owned banks (local banks). The author concentrates on analysing the failures of local banks. Factors highlighted are “low level of bank capitalisation, access to public sector deposits through political connections of bank owners, excessive ownership concentration, and regulatory forbearance...and high costs of deposit mobilization” (Brownbridge 1998a p. 186).⁸⁴ The author concludes that regulatory policies need to enhance the incentives faced by banks to take lower levels of risk.

3.8 Studies on the Ability of Banks to Mobilize Deposits in Africa

In Chapter 1 we discussed that deposit mobilization, measured in terms of liquid liabilities to GDP ratios, is very low in SSA. As discussed in Chapter 2, it was argued by the proponents of financial liberalization that the deposit mobilization by banks would increase once ceilings on interest rates fixed by governments were removed (Fry, 1988; McKinnon, 1973; Shaw, 1973). However this prediction has not materialized with financial liberalization.

⁸⁴ Interestingly they find that deposit insurance was prevalent but not a crucial factor in contributing to moral hazard as the level of deposit insurance was very low. However, there was a high level of liquidity support provided by the Central Banks for long periods before banks were closed. This regulatory forbearance was an important factor in increasing moral hazard of bank owners / managers (Brownbridge 1998 p. 182).

It has been argued that the low deposit ratios in SSA are affected by capital flight as Africa has amongst the highest ratios of offshore deposits to domestic bank deposits (Honohan & Beck, 2007). There has also been recognition that amongst government owned banks and private politically connected banks, there is an over-reliance on government and parastatal deposits which can be unreliable if there is a change in government (Brownbridge, 1998b). Besides this, there is very little work done on the constraints that banks face when raising deposits. It can be argued that the overemphasis in the literature on the moral hazard issues surrounding deposit insurance schemes means that not enough attention has been placed on the actual ability of banks to raise deposits.

Yet, as will be shown in Chapter 6, this remains a key constraint facing banks in Kenya and has a strong impact on competition amongst banks.

3.9 Concluding Remarks

This chapter reviews the literature on the financial sector in Sub-Saharan Africa. There is a general recognition in the literature that financial sector liberalization did not generate the fruits expected. In this area there is work from both the mainstream and heterodox schools attempting to understand the reasons for the failure of liberalization.

Secondly, it shows that in contrast to the vast literature from both the mainstream and the heterodox schools on micro finance and informal finance in SSA, there is very little heterodox work done on the formal banking sector in SSA.⁸⁵ The majority of studies on the formal banking sector are from the mainstream school. The first set of studies consists of large Africa wide, econometric cross-country studies that attempt to understand the links between finance and growth. There are also cross-country studies that consider macro-economic factors and micro-economic bank level factors that can in theory explain the shallowness and fragility of the banking sectors in SSA. These are weak, as they make no attempt to understand the individual country specific problems of different economies in SSA. Single country case studies consists of studies that follow

⁸⁵ A review of heterodox African scholars who presented the Annual Conference on Development and Change in South Africa in 2007 shows that, there is some heterodox work in particular in the areas of growth, trade, poverty and environment (Jacobs, 2008). However, it is useful to highlight that this conference did not feature even one paper on finance or on banking in SSA.

a ‘Structure-Conduct-Performance’ paradigm where it is assumed that the poor performance of African banking, and in particular high interest rate spreads, can be attributed to high levels of concentration and low levels of competition. These are flawed in their very simplistic understanding of competition. There are also country case studies that attempt to understand the efficiency of banks in SSA. This chapter presents criticisms of these studies in terms of methodology. In particular, it has been shown that these papers, are misguided as they place mathematical and econometric rigor above theoretical and practical rigor and lead to extremely misguided conclusions in particular in the case of Aikaeli (2006, 2008). There are also single country case studies that attempt to understand bank failures in SSA. However, it has been shown that their application of the models is tautological. In attempting to explain bank failures, high non-performing loans or low profitability are used as dependent variables. There is little analysis of why the loans turned into non-performing loans that actually led to bank failures or low profitability.

Mainstream economics is dominated by neo-classical economics and has been criticised as appearing to become more scientifically rigorous with an increased focus on econometrics but having less ability to explain economic phenomena (Hodgson, 2001; Lawson, 1997; Milonakis & Fine, 2008). This chapter has shown that the dominance of the mainstream is extremely overwhelming in the work done on SSA. In a tribute to the Cambridge economist Ajit Singh, it has been argued “To sum up, as an economic researcher, Ajit has been guided by the W.B. Reddaway dictum (paraphrased here) *that it is better to be technically crude and relevant than to be technically sophisticated and irrelevant*” (Arestis & Eatwell, 2008 pp., 5).⁸⁶ This chapter has demonstrated that there is a whole generation of African economists who are being trained to be *technically sophisticated but irrelevant*. This does not bode well for the future development of the continent. As has been argued by Mamdani, there can be no ‘African Renaissance’ without an African-focused intelligentsia to drive it (Mamdani, 1999). In line with other pluralist economists, this chapter is also a plea by the author for African economists to follow heterodox and pluralist methodology and methods.⁸⁷

⁸⁶ Ajit Singh in turn, in a tribute to W.B Reddaway, analyzes the methods of this research and emphasizes that it is possible to carry out high quality research without using mathematical equations or formalistic modeling methods (Singh, 2009).

⁸⁷ See Appendix 6, which displays a copy of an advertisement which appeared in the American Economic Review of 1982 in which 44 eminent economists have called for more pluralism of method in economics.

CHAPTER 4 – THE KENYAN BANKING SECTOR

“A sustainable economic recovery programme requires a vibrant and integrated financial sector that ensures mobilization of adequate financial resources to finance the required investment. Although the financial sector in Kenya is fairly diversified in terms of financial institutions, removal of those factors that have constrained effectiveness of the financial sector’s intermediation role is necessary. The Government will therefore carry out a comprehensive study of the financial sector to identify weaknesses that have impeded growth of the sector and reforms that are needed to strengthen its’ intermediation role.”

Republic of Kenya (2003 pp., 41)

4.1 Introduction

This chapter discusses the historical evolution of the banking sector in Kenya up to the period of focus of this thesis (2000-2005). Section 4.2 provides a historical background from the colonial period to the post independence period and during the liberalization process which started in the 1990s. Section 4.3 analyzes the key trends in the banking sector during the post independence period. Section 4.4. provides a critical review of the studies on the banking sector in Kenya. Section 4.5 introduces the concept of segmentation and analyzes the performance of banking sector during 2000-2005 using a segmentation approach. This analysis is based on financial statement data collected by the author. This section forms the basis of the rest of the thesis where we attempt to understand the constraints faced by the banking sector in Kenya and the sources of this segmentation.

4.2 Historical Overview of the Development of Banking in Kenya

4.2.1 Banking in Colonial Kenya – Origins 1896 to 1950

The establishment of the British Empire in East Africa began with the establishment of a trading frontier under the agency of Imperial British East Africa Company (IBEAC) incorporated in United Kingdom in 1888. IBEAC sought to inherit the centuries old long-distance trade that linked the African interior to the African coast, and from the African Coast to the Indian sub-continent through the Indian Ocean. Colonial rule was formally established with the declaration of the East African Protectorate in 1895 under

the sovereignty of the Sultan of Zanzibar. Construction of the Uganda Railway (later East African Railway) began in 1896 from the East African coast at Mombasa and reached the point that would become the capital of modern Kenya, Nairobi in May 1898. The railway reached what was to become modern day Kisumu in western Kenya on the shores of Lake Victoria in 1902. The railway was constructed by over thirty thousand of labourers brought on contract from the provinces of Punjab and Gujarat in (undivided) British India. They formed the basis of the Asian community that settled in Kenya (Mangat, 1968; Seidenberg, 1996). The deliberate policy of European settlement began in 1902. In 1920, the nominal sovereignty of the Sultan of Zanzibar was confined to a ten mile strip along the coast, which the British then rented from the Sultan. The country was renamed Colony and Protectorate of Kenya (Atieno-Odhiambo, 2000; Hazlewood, 1979).

The origins of commercial banking in Kenya lay in these commercial connections between British East Africa and British India at the close of the 19th century. The first two British banks to be established were the National Bank of India in 1896 and the Standard Bank of South Africa in 1910. The former became National and Grindlays Bank and the later became Standard Bank. National Bank of South Africa was established in 1916 but was later merged with Colonial Bank and Anglo-Egyptian Bank to form Barclays Bank (Dominion, Colonial and Overseas) in 1926 which was also based in London.

The most important point to recognize is that while commercial banking become relatively well established in Kenya during the colonial period, the banks showed little interest in the indigenous African population. As branches of metropolitan banks they were designed to settle accounts of the colonial economy and therefore not interested in encouraging savings amongst Africans or financing African enterprise (Engberg, 1965; Mkandawire, 1999). It has been further argued that banks did little to help even their main customer base - the white settler community that was dominated by farmers:

“..... these banks lent money to the farmers at [interest rates of] anything from 8 to 10 per cent. When crisis came [after the First World War] they operated their traditional policy and shut down on credit at the moment when it was most required. When European farmers were mortgaged to the hilt and the wages of Africans were at least halved, these banks remained woefully prosperous. Throughout the crisis the Standard Bank of South

Africa did not declare a dividend of no less than 10 per cent..... A good deal of property as well as money passed into their hands during these years. Organised to *take money out of the colony*, there is little evidence that the banks have proved adventurous in promoting industrial development in Kenya.”

Aaronovitch & Aaronovitch (1947 pp., 177)⁸⁸

Interestingly, the restriction of credit by the three banks led to pressure on the government to relieve the heavily indebted white farmers. The colonial government established The Land Bank in 1931 as a source of alternative credit. However, it has been observed that the private banks benefited more than farmers, as 39% of the funds of the Land Bank were used to discharge existing mortgages with the private bank and therefore not increase the total availability of credit (Aaronovitch & Aaronovitch, 1947). Furthermore, though the mandate of The Land Bank included provision of credit to ‘native farms’, the skewed land tenure system where the lion’s share of African land was held under communal tenure, made it impossible to lend to ‘native farms’ and by 1945 only one African farmer had benefited from The Land Bank (Aaronovitch & Aaronovitch, 1947; Maxon, 1992).

4.2.2 Pre-Independence Growth – 1950 - 1963

It was not until the 1950s that other banks began to be established. These banks were mainly single branch banks, headquartered in Nairobi with a focus on trade finance (Central Bank of Kenya, 1976; Engberg, 1965).

There are other structural features that should be noted. First, there was no central bank fulfilling the function of lender of last resort. In its place was the East African Currency Board (EACB) with the limited function of maintaining a strict parity between the East African shilling and the British Pound.⁸⁹ Therefore, the supply of credit was fully

⁸⁸ Emphasis added.

⁸⁹ The establishment of the EACB in 1919 led to the introduction of East African florin in 1920 and the East African shilling in 1922. Prior to that, the currency of use in East Africa was the Indian Rupee due to centuries old trade connections between India and East Africa. However the fluctuations in value of the Indian Rupee in relation to sterling during the first world war led to the establishment of the EACB (Central Bank of Kenya, 1976). The Board operating through commercial banks issued shillings at a fixed exchange rate of East African Shillings 20 for every £1. The Board had all its assets in United Kingdom securities and all its currency issue had to be fully backed by foreign exchange (Hazlewood, 1979).

determined by the commercial banks. Commercial bank advances consisted of their own resources and funds borrowed from parent banks. Funds moved freely from parent bank to their branch as there were no capital account restrictions. Secondly, prudential regulation was very lenient with no statutory liquidity or cash requirement ratios (Central Bank of Kenya, 1976, 1986).⁹⁰ Thirdly, there was very little effort amongst the banks to compete for deposits. Interest rates on deposits and loans were determined by collective (cartel-type) bank arrangements decided by the three major banks, and subscribed to by the other banks (Engberg, 1965).

Table 11: Monetization, Assets and Deposits held by Banks in East Africa 1950 – 1963

Year	Total Deposits	Local Earning Assets	Local Earning Assets As % Of Total Deposits	Loans And Advances	Loans And Advances As % Of Total Deposits
	£m	£m	%	£m	%
1950	64	22	34	17	27
1960	87	78	90	69	80
1963	121	105	87	93	77

Source: Engberg (1965)

Note:-

- 1) It has not been possible to get a breakdown of these figures between the three East African countries (Kenya, Uganda and Tanzania).

Table 11 shows that between 1950 and 1963, the levels of deposits, assets and loans held by commercial banks in East Africa (and therefore Kenya) grew substantially.

It has been documented that the banks tended to be very conservative applying credit standards set by their head offices and these were not realistic in the extremely under-developed countries in which they were operating (Engberg, 1965). The unwillingness

⁹⁰ The first three banks to be established during the colonial period were regulated by the Banking Ordinance of 1910. This Act was repealed and replaced by the Banking Ordinance of 1956 which specified for the first time, minimum capital requirements for banks and established a Registrar of Banks with power to license banks. The minimum capital was set at East African Shillings 2 million (approximately US \$ 0.28 million).

of banks to extend credit led to a situation in the 1950s where there was an *export* of capital from the underdeveloped periphery to the developed metropole (Maxon, 1992).

The second important point to note is that the safety of the deposits held by the branches of the main banks did not depend on the quality of assets of these banks in East Africa but were linked to the capital and reserves of the parent banks overseas. Therefore, when large withdrawals of deposits took place in 1955, 1960 and 1963, the banks were able to use the inter-bank borrowing facilities of their London Head Office (Abdi, 1977). This point is crucial to keep in mind for our discussion below on segmentation – foreign banks had already established a reputation as ‘safe banks’ before independence.

On 30th June 1963, on the eve of independence, there were nine banks operating in Kenya.⁹¹ Table 12 lists these banks.

Table 12: Banks Operating in Kenya in 1963

Nationality (Place of Incorporation)	Date of Incorporation	Number of Offices in East Africa
British	1896	70
British	1910	65
British	1916	119
Dutch	1951	4
Indian	1953	5
Indian	1953	10
Pakistani	1956	1
Turkish	1958	8
Tanzanian	1958	3

Source: Engberg (1965) and Central Bank of Kenya (1986)

Notes:-

- 1) There are conflicting figures on the exact number of branches. Engberg (1965), quoted in the table above, states that total branches in East Africa (Kenya, Uganda and Tanzania) was 302 the ‘big three’ banks controlling 254 branches and total number of branches in Kenya was 161. However, Onyonka (1968)

⁹¹ In 1963, there were 13 banks operating in East Africa (Engberg, 1965).

quoted in Maxon (1992) states that by the middle of the 1960s the 'big three' banks held 147 of a total of 178 branches in Kenya.

- 2) It has not been possible to establish the exact size of these banks in terms of asset base in 1963. However, Barclays D.C.O was also the largest in terms of asset size (Onyonka, 1968 quoted in Maxon 1992).

The financial sector also included three private non-bank financial institutions (NBFIs) - Diamond Jubilee Investment Trust established in 1946; Credit Finance Corporation in 1955; and National Industrial Credit in 1959. In addition there were two private housing finance companies - Savings and Loans in 1949 and East African Building Society in 1959 (Central Bank of Kenya, 1972, 1986). Though it has not been possible to find the exact figures for the asset base of these financial companies at independence, it would be reasonable to assume that they were very small compared to the banks.⁹²

In summary, at independence in 1963, the first three banks to be established in Kenya continued to dominate the banking sector controlling about 85% of the total branch network (Engberg, 1965). It is also important to note that the data in Table 12 highlights that at independence all banks were foreign owned and there were no bank that could be termed 'local'. Furthermore, all non-bank financial institutions were British owned except Diamond Jubilee Investment Trust, which is the only financial institution whose ownership can be termed 'local' at independence.⁹³ Finally, all financial institutions primarily concerned themselves with trade finance with very little interest in lending.

4.2.3 Harambee - Creation of Government Owned Banks – 1963 - 1980

The post independence bank developments started with the establishment of the Central Bank of Kenya (CBK) in 1966 after the dissolution of the EACB. Kenya's first national currency - the Kenya Shilling (KShs.) was introduced on 14th September 1966 at the rate of KShs. 20 to the pound (Central Bank of Kenya, 1976). At independence in 1963, the prevalent understanding was that development entailed massive resource

⁹² These NBFIs were restricted from raising deposits and were also single branch institutions.

⁹³ Diamond Jubilee Investment Trust was set up by members of the Ismaili community (a sub-community of the Asian-African community) to commemorate the Diamond Jubilee (60th anniversary) of leadership of His Highness Aga Khan III of the community.

mobilization and banks were seen as key instruments in this resource mobilization. However, in Kenya, unlike most African countries there was no wholesale nationalization of all banks. This can be seen as part of the broader strategy by Kenyan leaders at independence to accommodate colonial interests and prevent a wholesale migration of foreign capital (Leys, 1975). At independence, the first President Jomo Kenyatta assured the white settler community:

“The Government of independent Kenya will not be a gangster Government. Those who have been panicky...can now rest assured that the future African Government...will not deprive them of their property rights of ownership. We will encourage investors...to come to Kenya... to bring prosperity to this country.”

Quoted in Ndege (2000 pp., 107) and Hazlewood (1979 pp., 13)

Therefore international banks, now classified as foreign owned banks, including Barclays D.C.O. and Standard Bank, continued to operate in Kenya.⁹⁴ Only the National & Grindlays Bank was bought out by the Government of Kenya (GoK) and became the Kenya Commercial Bank (KCB) (Central Bank of Kenya, 1986).⁹⁵ In 1974, two American banks were established – the First National Bank of Chicago and the First National City Bank of New York (Nasibi, 1992).

In the 1960s, Kenya experienced impressive economic growth mainly driven largely by commercialization of African smallholder agriculture. In the first decade of independence, GDP at constant prices grew at an annual rate of 7.1% (Hazlewood, 1979). The M2 to GDP ratio increased from 19% in 1963 to 30% in 1970 (Central

⁹⁴ In the 1970s, Standard Bank became Standard Chartered Bank Ltd and Barclays Bank D.C.&O changed its name to Barclays Bank International Ltd., both becoming wholly owned subsidiaries of the parent banks in London (Central Bank of Kenya, 1976).

⁹⁵ This was part of the resource mobilization and Africanization strategy of the government discussed below. The purchase of National and Grindlays Bank was on a willing seller, willing buyer basis. In 1968 the Ottoman Bank was taken over by National and Grindlays Bank. Then in 1970 an agreement was reached between National and Grindlays Bank and the Government. The bank was split into an international bank in which the Government took a 40% share, and the local branch system of the bank, renamed Kenya Commercial Bank, in which the Government took a 60% share. The remaining share were quoted on the London and Nairobi stock exchanges respectively (Hazlewood, 1979).

Bank of Kenya, 1986).⁹⁶ However there was government dissatisfaction with the pace of adjustment, in particular with the very low loans to deposit ratio of 64.6% in 1969 (Republic of Kenya, 1968).⁹⁷ It was argued:

“that the urgency of development is so great, that the need for specialized institutions for the collection of savings and investment cannot be left to the process of slow evolution.”

Republic of Kenya Development Plan 1969-1974 (1968 pp., 558)

Therefore there was an understanding that economic development entailed massive resource mobilization and that these resources could be raised through banks. There was also the political reality that needed to be addressed – the need for visible ownership in the Kenyan economy by African Kenyans and the government’s stated policy of Africanization was also pursued through the financial system. The government also established two new banks – Cooperative Bank and National Bank of Kenya in 1968. Specialized credit institutions or Development Finance Institutions (DFIs) including the Industrial & Commercial Development Corporation (ICDC), the Industrial Development Bank (IDB), the Development Finance Corporation of Kenya (DFCK) and the Agricultural Finance Corporation (AFC) were set up to give loans to Kenyans and also purchase shares in public corporations (Grosh, 1991).⁹⁸

There was also growth of local financial institutions, termed ‘indigenous’ banks between 1971 – 1980, one local private bank and nine local NBFIs were established (Kariuki, 1993). These financial institutions were mainly owned by African (Kikuyu) businessman who had built up capital during the Coffee Boom of 1976 – 1979 due to their close links to President Kenyatta who was also from the Kikuyu ethnic group (Throup, 1987). The commercial banks and NBFIs were largely free from regulatory controls except the stipulation of lending and deposit interest rates (Brownbridge, 1998b). There was a

⁹⁶ Refer to Chapter 1 for definitions of M0, M1, M2, M3 and other measures of financial development and also why liquid liabilities to GDP ratio has replaced M2 to GDP as one of the main indicators of financial deepening.

⁹⁷ Therefore, the loans to deposit ratio was even lower than the figure in 1963 of 77%.

⁹⁸ ICDC was originally incorporated in 1954 as Industrial Development Corporate (IDC) to assist and encourage medium-and large scale investment in the industrial sector. In 1973 IDB was set up as a subsidiary of ICDC. However, ICDC, DFCK and IDB had overlapping and duplicating roles (Grosh, 1991).

condition that banks should extend credit to agriculture amounting to 17% of their deposits, but this was requirement was rarely enforced (Kariuki, 1993).

The M2 to GDP ratio throughout the 1970s and 1980s remained at approximately 30%. However there was some financial deepening as the loans to deposits ratio grew from 64.6% in 1969 to 80% by 1980. The level of financial institutions (banks and NBFIs) assets to GDP ratio grew from 28% in 1971 to 40% in 1980 (Ngugi, 2000).⁹⁹

4.2.4 Nyayo – The Rise of Indigenous and Political Banks – 1980 - 1990

On the death of President Kenyatta in 1978, he was succeeded by President Moi who was from the Kalenjin community. The watchword chosen by Moi for this Presidency was *Nyayo*, meaning footsteps; emphasizing continuity with the economic policies of the Kenyatta era by remaining committed to a capitalist economy with a focus on attracting foreign investment and maintaining policies of Africanization of the economy (Maxon & Ndege, 1995).

The 1980s witnessed the growth of a large number of NBFIs which increased from 20 in 1980 to 53 in 1990 (a rise of 165%) and the number of banks grew from 17 to 20 (a growth of 17%).¹⁰⁰ The majority of these new financial institutions were owned by local entrepreneurs (Kariuki, 1993). These local banks fulfilled a very useful function as they catered for mainly small and medium sized enterprises, often from their own communities, that the foreign owned banks and the government owned banks did not serve (Nasibi, 1992).

However the proliferation of local banks and NBFIs was also facilitated by several political and regulatory factors. Firstly, regulatory barriers including the minimum capital requirements and reserve ratios were very low compared to banks (Brownbridge, 1998b). In particular, the minimum capital requirements for NBFIs were extremely low even

⁹⁹ It should be noted this ratio is different from the private credit to GDP ratio as it includes public as well as private lending and also includes liquid assets which are not lent out.

¹⁰⁰ Refer to Table 13. It should be noted that it has been difficult to get data on the exact number of banks that opened and closed each year. In particular it has been difficult to get the exact number of banks in 1983 before large number of bank failures in 1984. Therefore these trend figures do not capture the full details of the movements in the number of banks.

though they were allowed to take deposits.¹⁰¹ There was a regulatory ‘arbitrage’ between banks and NBFIs and therefore most banks (including foreign owned and government owned banks) started a NBFI as a subsidiary to take advantage of this regulatory loophole.¹⁰² Secondly, political interference subverted prudential criteria in the awarding of licenses as Section 53 of the Banking Act gave the Minister of Finance authority to grant exemptions to the Act (Brownbridge, 1998b).¹⁰³ Thirdly, many banks had prominent politicians on their boards and were able to use these connections to obtain public sector deposits very cheaply (Brownbridge, 1998b; Ndi, 1994). Fourthly, the CBK has very little capacity to supervise the growth of financial institutions (World Bank, 1989). As will be seen below, these factors sowed the seeds of weakness in the banking system from the very establishment of these NBFIs.

Furthermore, during the first decade of the Moi era, due to external and internal economic factors, Kenya experienced severe reduction in GDP growth and macroeconomic imbalances, including declining terms of trade and budget deficits, and was forced into undertaking structural adjustment policies recommended by the IMF and the World Bank (Ngugi, 2000).¹⁰⁴

The banking system was considered repressed in the McKinnon-Shaw context as interest rates up to the early 1980s were low and negative in real terms (Mwega, Ngola, & Mwangi, 1990). It was acknowledged that:

“it had been official policy in Kenya since independence to follow a ‘low interest rate policy’ in order to encourage investment and to protect the small borrower”

Central Bank of Kenya (1986 pp., 54)

¹⁰¹ From 1963 - 1980, minimum share capital for banks remained KShs. 2 million and the minimum share capital of NBFIs was KShs. 500,000/- (Brownbridge, 1998b). See Table 14 for a list of capital requirements of the Central Bank of Kenya from 1956 onwards.

¹⁰² This policy was reversed in 1993 as will be discussed below.

¹⁰³ The Banking Act is Chapter 488 of the Laws of Kenya and The Central Bank of Kenya Act is Chapter 491 of the Laws of Kenya. See www.centralbank.go.ke

¹⁰⁴ The main external factor was the oil price shocks of 1973 and 1979 and the key internal factor was the drought of 1979 and 1984 (Ngugi & Kabubo, 1998). From the average rate of 7.1% GDP growth (mentioned above), growth fell to 3.9% in 1980, to a low of 0.8% in 1984 but grew again to 5% by 1989.

The main structural adjustment policy relating to the financial sector was a gradual increase in interest rates and real lending rates of banks increased from -2.5% in 1980 to 9% in 1990 (Brownbridge, 1998b).

The rapid rise of financial institutions, very poor regulation, shifting political economy trends and also declining economic growth resulted in the failure of twelve banks between 1984 and 1989 (see Table 13). In December 1989, nine of these banks were taken over by the government to form the Consolidated Bank (Ngugi, 2000).¹⁰⁵ A more detailed discussion on the reasons for bank failures, in particular the political economy shifts, is discussed below. In 1989, there was a major amendment to the Banking Act and Central Bank of Kenya Act establishing stricter guidelines for licensing of institutions and establishing single borrower limits (Nasibi, 1992).¹⁰⁶ In 1989 the Deposit Protection Fund Board was also established to compensate small depositors in case of bank failures. This institution also assumed responsibility for liquidating failed banks (Nasibi, 1992).

This section has shown that the banking sector in Kenya immediately prior to full scale liberalization in the 1990s was fragile. Despite the increase in the number of financial institutions to 94 in 1990, M2/GDP ratio and loans to deposit ratio of banks remained constant throughout the 1980s at about 30% and 80% respectively. Furthermore, the total financial institutions assets to GDP ratio rose only marginally from 40% in 1980 to 41.6% in 1989 (Central Bank of Kenya, 1986; Ngugi, 2000).¹⁰⁷

¹⁰⁵ These are Union Bank, Jimba Credit Corporation, Estate Finance, Estate Building Society, Business Finance, Nationwide Finance, Kenya Savings and Mortgages, Home Savings and Mortgages, and Citizens Building Society (Brownbridge, 1998b; Nasibi, 1992).

¹⁰⁶ The Central Bank of Kenya Act was only tinkered with from 1969 to 1984. In 1985, it was overhauled. The key amendments were that first, applications for license of banks had to go through the CBK and not directly to the Minister of Finance; second, minimum capital requirements were increased to KShs. 15 million; and third, single borrower limits were set at 100% of share capital (Central Bank of Kenya, 1986). See Table 14 for a list of changes in capital requirements through the years.

¹⁰⁷ Ngugi (2000) argues that this is because the M2/GDP figure does not take into account assets and liabilities of NBFIs. She shows that NBFIs assets as a percentage of GDP grew from 12.1% in 1980 to 22% in 1984 but dropped again to 14.5% in 1989, while bank assets as a percentage of GDP was constant at around 28% throughout the decade. However, she does not give a figure of the loan/deposit ratio of NBFIs. It estimated that M3 to GNP ratio increased from 38% in 1973 to 45% in 1985 (Mwega et al., 1990).

4.2.5 Early Liberalization 1990 - 1994

Following the structural adjustment programs of the 1980s, which were focused on debt and budget reform and only contained minor financial sector reforms, Kenya embarked on full-scale financial liberalization in the 1990s. Unlike other African countries the official reports of the Kenyan Government lauded the success of the structural adjustment programs of the 1980s (Nasibi, 1992).¹⁰⁸ Liberalization of the financial sector was financed by the World Bank's Financial Sector Adjustment Credit (FSAC) which was approved by the board of the World Bank in June 1989. The theoretical basis of financial liberalization was based on the McKinnon-Shaw hypothesis discussed in Chapters 2 and 3, where government control of interest rates was seen as a key constraint to financial sector development.¹⁰⁹

The key step of full scale financial liberalization was the complete deregulation of interest rates in 1991 (Brownbridge, 1998b). In 1992, commercial banks were authorized to deal in foreign exchange, and in 1993 a market-determined flexible exchange rate system was adopted for the Kenya Shilling (Brownbridge, 1998b). While liberalization was taking place, there were big political changes also taking place and in 1992, Kenya had its first multi-party elections. President Moi was returned to power due to an extremely fractured opposition. However funding for the elections left the public finances in disarray. In particular, government borrowing jumped and this is reflected in the Treasury bill rates. In March 1993, the 91 one day Treasury bill rate was 25%. This jumped to 46% in April 1993, peaking at 85% in July 1993 and then dropping steadily but remaining still very high at 44% in December 1993.¹¹⁰

¹⁰⁸ It should be noted that in Kenya the clamour for liberalization was not only external. Leaders of the private sector, including several chairmen of the Kenya Association of Manufacturers (the principal manufacturing and trade lobby group) were calling for a deregulation of interest rates and commodity prices (Nasibi, 1992). Though it should be noted that there were differences in positions between export oriented manufacturer such as textile manufacturers who opposed the liberalization and import oriented manufacturers who lobbied for the liberalization.

¹⁰⁹ The references to the McKinnon-Shaw hypothesis are explicit. The objectives of financial liberalization were stated as "to encourage mobilisation of savings and contribute to the maintenance of financial stability...and to ensure that funds flow into those areas which are most productive, and that the biases which have existed against lending to small business are eliminated" Central Bank of Kenya (1988 pp., 18) quoted in Kariuki (1995 pp., 6).

¹¹⁰ Data for Kenyan GDP growth rates, inflation rates, exchanges rates and T bill rates from 1990 – 2005 are displayed in Appendix 7.

This liberalization of interest rates and exchange rates provided further avenues for local banks to compete with more established banks, and was an added stimulus for local bank entry (Brownbridge, 1998b; Ndung'u & Ngugi, 1999). While the 1980s witnessed the rise of African (mainly Kikuyu) banks, the late 1980s and 1990s witnessed the rise of several African (Kalenjin) and Asian-African banks.¹¹¹ By the mid- 1990s, it is estimated that local banks controlled about a quarter of the market (Brownbridge, 1998b).¹¹² Table 13 below shows the growth in the total number of financial institutions from 1990 up to 1993. The total number of banks grew by 67% and the total number of NBFIs grew by 13%.

Table 13: Number of Financial Institutions in Kenya

	1963	1975	1980	1990	1993	1994	1997	1998	2000	2003	2005
Banks	9	14	17	24	40	37	53	53	49	43	41
NBFIs	3	8	20	53	60	44	19	15	5	3	3
Building Societies	2	2	2	17	11	6	6	4	4	6	1
Total	14	22	39	94	111	87	78	72	58	52	45

Source: Engberg (1965), Brownbridge (1998b), Central Bank of Kenya (2000a, 2003, 2005)

However, as will be shown below, the experience with liberalization in terms of financial deepening was very unsatisfactory.

¹¹¹ Asian-African community is a new label of identity being used by people of Indian origin who settled in Kenya (The Asian-African Heritage Trust, 2000). This community is often also referred to as Kenyan-Asians, East African- Asians or South Asian-Kenyans.

¹¹² It has not been possible to get disaggregated data at segment level on banks assets for the periods before 2000.

4.2.6 Consolidation and Changes in Regulation 1994 - 2005

After 1994, there has been a decline in the total number of institutions. This was partly due to the failure of fifteen financial institutions (see Table 17 below). Furthermore, in 1993 the Central Bank of Kenya adopted a universal banking policy and reduced the regulatory advantages that were available to NBFIs. This led to several NBFIs converting to banks or merging with their parent bank and led to a consolidation of the banking sector (Ngugi, 2000).

Throughout the late 1990s and up to 2005, the CBK Act and the Banking Act were amended to improve regulation and supervision of the banks.¹¹³ In October 1995, key amendments included the harmonisation of banks accounting financial year, the approval of bank auditors by the CBK and reduction of single borrower limit to core capital ratio from 100% to 25% (Central Bank of Kenya, 1995, 1996).¹¹⁴ In 1997, the responsibilities for appointing of the Governor and management of the CBK was transferred to a board of directors appointed by the President rather than directly by the Minister of Finance to reduce political interference in the CBK (Central Bank of Kenya, 1997). In response to the spate of bank failures of 1998, several changes were brought into force in 1999.¹¹⁵ Detailed guidelines on provisioning for non-performing loans were set out and there was a requirement for banks to publish their accounts including details on their non-performing loans in the national press (Central Bank of Kenya, 1999).¹¹⁶ Minimum capital was increased to KShs. 200 million by December 1999. In October 2000, minimum capital requirements were increased to Kshs. 250 million. Table 14 summarize the changes in the minimum capital requirements for banks in Kenya from 1956 onwards.

¹¹³ President Moi did not contest the December 2002 elections and in 2003, President Mwai Kibaki became the third President of Kenya as head of NARC – the National Rainbow Coalition – a coalition of parties of which the two largest parties were the NAK (National Alliance Party of Kenya) and LDP (Liberal Democratic Party of Kenya).

¹¹⁴ The single borrower limit is aimed to reduce exposure to one borrower. The previous limit of 100% meant that a single non-performing loan to one borrower could wipe out the entire capital of a bank.

¹¹⁵ A detailed discussion of bank failures is in Section 4.3.5 and Section 4.4.6 below.

¹¹⁶ Refer to Chapter 6 for more specific details on the regulation in relation to lending.

Table 14 : Regulatory Minimum Capital Requirements for Banks in Kenya

Year	KShs. Million	USD Million
1956-68	2	0.28-0.28
1968-80	2	0.28-0.27
1980-82	5	0.67-0.46
1982-85	10	0.92-0.61
1985-92	15	0.91-0.41
1992- 1999	75	2.07-1.37
31/12/1999	200	2.74
31/12/2000	250	3.20
31/12/2005	250	3.45
31/12/2009	350	4.61
31/12/2010 (proposed)	500	6.2
31/12/2011 (proposed)	700	8.7
31/12/2012 (proposed)	1000	12.4

Source:- Brownbridge (1998b), Central Bank of Kenya (2000b, 2006b, 2008)

Note:-

- 1) The minimum capital requirements were stipulated in Kenya shillings and remained constant during each of the periods. The dollar value fluctuated depending on the exchange rate and the values quoted are for the beginning and end of the period.
- 2) The proposed increases in the minimum capital requirements were presented in the Government of Kenya's Budget Speech 2008/2009 and are recorded in the Banking Act, Schedule 2, version dated January 2009 (Anyanzwa, 2009).
- 3) The USD figures for 2010, 2011 and 2012 are calculated based on the exchange rate of October 2010.

In October 2000 guidelines were issued requiring banks to conform to the Basle Capital Accord in terms of the composition of capital and also new regulatory capital ratios were specified. These are listed in Table 15.

Table 15: Regulatory Capital Ratios of Banks in Kenya

Ratio	Minimum Requirement
Core Capital/TRWA	8.00%
Total Capital/TRWA	12.00%
Core Capital/Total Deposits	8.00%

Source:- Central Bank of Kenya (Central Bank of Kenya, 2000b)

Notes:-

- 1) These guidelines were brought into force in October 2000 and meet the Basle Capital Accord ('Basle 1) capital requirements.
- 2) TRWA stands for total risk weighted assets. Guidelines for risk weighting of different asset classes is also specified in the Central Bank of Kenya Prudential Guidelines of 2000

The October 2000 guidelines also reinforced the single borrower limits to 25% of core capital, restricted lending to insiders to 20% of core capital, defined a large exposure as 10% of core capital and further restricting the lending to all large borrowers to five times the core capital (Central Bank of Kenya, 2000b).

As will be seen below, following the introduction of these guidelines and the high levels of provisioning undertaken by banks, non-performing loans have fallen. However, there are still questions on the ability of the CBK to carry out its regulatory role comprehensively due to political interference and lack of capacity (Brownbridge 1998; Kagira & Kirkpatrick 2001; Brownbridge & Kirkpatrick 2002; Alawode 2003). Other financial deepening and financial efficiency indicators for this period are discussed below.

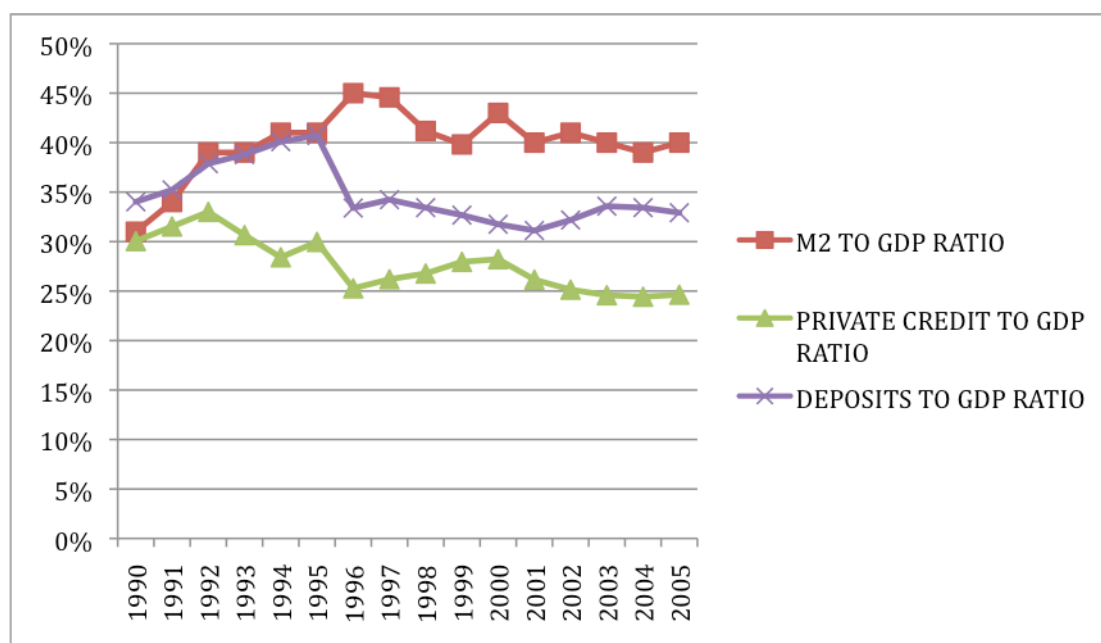
4.3 Trends in Key Banking Indicators 1990 - 2005

It was advocated that financial liberalization would increase savings, deposits, credit and growth (Ngugi, 2000). This section shows that in line with the experience of other SSA countries (discussed in Chapters 1 and 3) the results of financial liberalization in Kenya were extremely disappointing. While the banking sector has seen some improvements from 2002, the banking sector in Kenya in 2005 remains shallow and fragile.¹¹⁷

4.3.1 Financial Deepening Ratios

Figure 5 shows data on key financial ratios from 1990 to 2005.

Figure 5 : Financial Deepening Ratios 1990 – 2005



Source and Notes:-

- 1) M2 to GDP data from Central Bank of Kenya (Central Bank of Kenya, 2002b, 2006c). Data is for banks only.
- 2) Private credit to GDP ratio and deposits to GDP ratio data from World Bank Financial Structure Database (2000 - revised 2009). Data is for all financial institutions – banks and NBFIs.

¹¹⁷ As noted in Chapter 1, all the financial deepening and efficiency ratios for Kenya while favourable in terms of regional comparisons are poor in terms of international comparison. Refer to Table 1 in Chapter 1.

The first indicator, the M2 to GDP ratio rose immediately post liberalization from 31% to about 41% in 1995. The rise in M2 to GDP ratio in 1996 and 1997 to 45% can be attributed to the conversion of many NBFIs to banks, rather than an actual increase in financial deepening (Ngugi, 2000). Thereafter the M2/GDP ratio has hovered around the 40% mark till the end of 2005.

The second indicator, the deposit to GDP ratio rose initially due to the liberalization of interest rates to a high of about 41% in 1995. However after that it has fallen, and from the mid 1990s – 2005 stagnated between 30-35%.

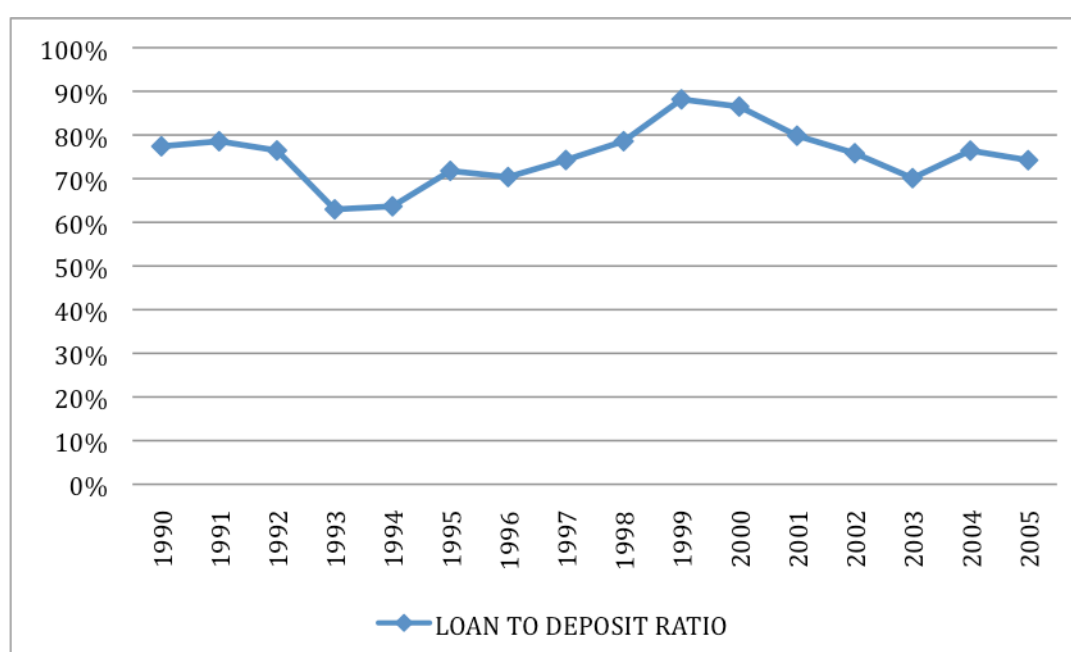
The key failure of liberalization is shown by the third indicator - private credit to GDP. After a small increase in this ratio in 1991 and 1992, the ratio has fallen and stabilized at just above 25% from 2000. This is well below the rate of 30% at the start of liberalization.¹¹⁸ This is despite the fact that public credit as a proportion of total credit has fallen from 25.94% in 1997 to 19.67% in 2005 (Central Bank of Kenya, 2006c pp., 21).

¹¹⁸ Due to data constraints on specific clients of banks, it is impossible to verify, but it can be reasonably argued that the small increase in lending in 1992 and 1997 were due to political lending associated with elections in Kenya during those years. Refer to the discussions below on bank failures linked to political lending.

4.3.2 Loan to Deposit Ratio

Figure 6 shows that the loan to deposit ratio after liberalization fell dramatically to almost 60% immediately after liberalization. This can be attributed to the high interest rate spreads experienced during the period of liberalization. After that it has recovered and by 2005 stood just below the 80%.¹¹⁹ This figure is adequate by international standards but as will be shown below, it does not take into account the high levels of non-performing loans experienced by the sector.

Figure 6: Loan to Deposit Ratio from 1990 - 2005



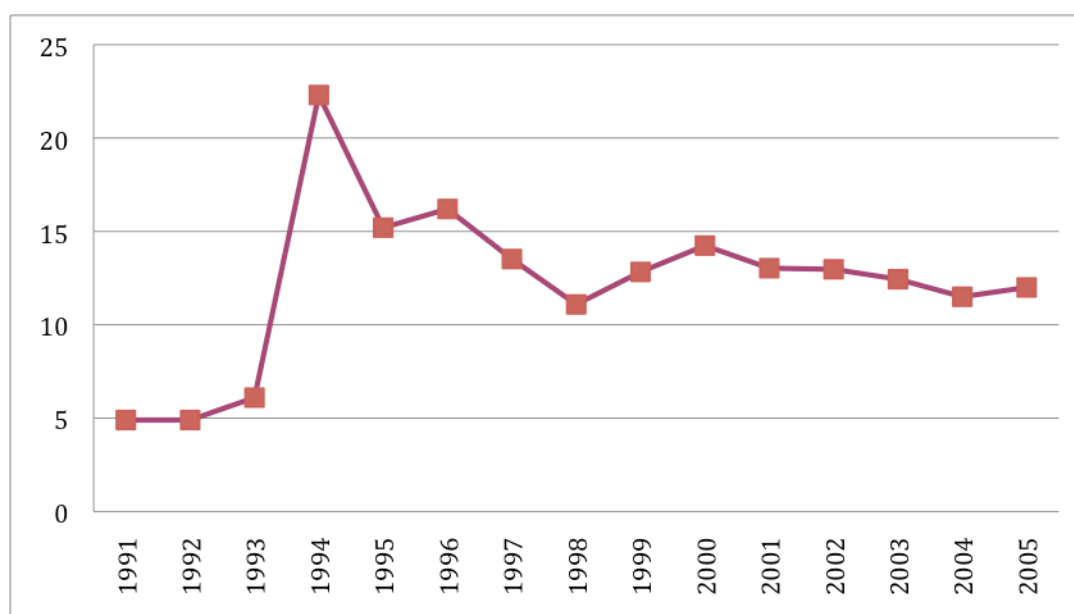
Source:- World Bank Financial Structure Database (2000 - revised 2009)

¹¹⁹ As the data source does not give full explanations on the movements to the data, it is difficult to explain why there is a steep rise in the loan/ deposit ratio from 79% in 1998 to 88% in 1999 and 87% in 2000. The ratio then drops again to 80% in 2001.

4.3.3 Interest Rate Spreads

Figure 7 shows the trend in interest rate spread after liberalization.¹²⁰ Immediately after liberalization, the spreads jumped dramatically. Though they have fallen from the highs of 1993, they are still relatively high. Mainstream economists recognize that liberalization theory failed to predict the high interest rate spreads and these spreads are a key reason why lending and therefore the private credit to GDP ratio did not increase after liberalization.¹²¹

Figure 7: Trend in Interest Rate Spread (%) in Kenya 1991 – 2005



Source: Ngugi (2004) and Beck *et al* (2010)¹²²

¹²⁰ Interest rate spread measures the differences between the weighted average lending rate on loans and advances and weighted average deposit rate on savings deposits.

¹²¹ A detailed discussion on interest rate spreads is in Section 4.4.4 below.

¹²² Ngugi (2004) is used for the data points from 1991 - 2003 as she is the main author who has worked on interest rate spreads in Kenya as will be seen below. Beck *et al* (2010) was used for the data points for 2004 and 2005. It should be noted that Beck *et al* (2010) provide data from 1998 to 2008. While the figure for 2003 is similar in both the papers, the figures for 1998 and 1999 are very different. The figure for 1998 in Ngugi (2004) is 11.09% compared to 18% in Beck *et al* (2010). The figure for 1999 in Ngugi (2004) is 12.83% compared to 19% in Beck *et al* (2010). This is despite both the original sources being quoted as CBK data. The author had requested the CBK to clarify these differences but was unable to get any conclusive answers. The differences may be due to differences in calculating averages.

4.3.4 Non Performing Loans

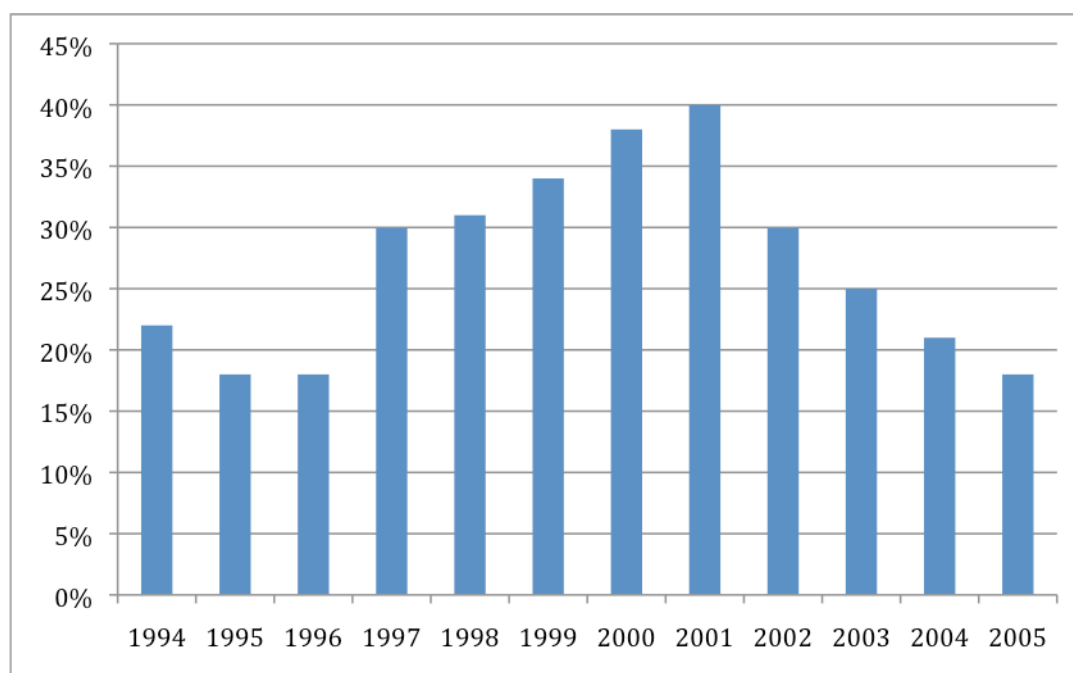
As discussed in Chapter 1, the level of non-performing loans (NPLs) in Kenya is high by regional standards. Table 16 and Figure 8 show the trends in non-performing loans in Kenya. This problem has been acknowledged by the CBK and each year the CBK Annual Supervision Report repeats the line, “non-performing loans continue to pose a major challenge” (Central Bank of Kenya, 2001).

Table 16: Trends in Loans, Non-performing Loans and Provisions for Banks and NBFIs in Kenya (KShs billion) 1994 – 2005

	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05
Total Loans	114	181	208	227	268	284	294	272	261	276	342	379
Non-performing loans (NPLs)	25	32	38	69	83	97	112	109	78	70	72	68
Provisions for NPLs	0	16	17	23	41	54	67	64	35	36	41	42
NPLs / Total loans (%)	22%	18%	18%	30%	31%	34%	38%	40%	30%	25%	21%	18%
Provisions/ NPLs (%)	0%	50%	46%	33%	49%	56%	60%	59%	45%	51%	72%	75%

Source: Central Bank of Kenya (2000a, 2001, 2002a, 2003, 2004, 2005)

Figure 8 : Non-performing Loans as a proportion of Total Loans (%) 1994 – 2005



Source: Central Bank of Kenya (2000a, 2001, 2002a, 2003, 2004, 2005)

The data shows that following liberalization and in particular after 1995, there was a dramatic increase in the non-performing loans in the banking sector to a high of 41% in 2001. There has been a fall in non-performing loans ratio from 2001. This was not only due to an increase in total loans (the denominator in the ratio) but due to high levels of provisioning. Referring to Table 16, it can be seen that provisions as a proportion of non-performing loans are over 70% in 2004 and 2005. As said above in 2000 the CBK brought in strict guidelines on provisioning of loans. Also Trust Bank was moved into liquidation and therefore the total non-performing loan figure declined as it was no longer considered within the banking sector.

Furthermore, this aggregate figure masks the differences in performance in terms of non-performing loans between segments as discussed below.

4.3.5 Bank Failures

Table 17 lists the names of the banks that failed in Kenya from 1984 to 2005. Four main periods of bank failures can be defined – 1984 – 1989, 1993 – 1995, 1998, 2000-2005. Brownbridge (1998b) distinguishes between three categories of local banks in Kenya: political banks (which have included prominent politicians amongst their shareholders) both African and Asian-African, independent (of politicians) Asian-African owned

financial institutions and independent (of politicians) African owned financial institutions.

While this is not the conventional distinction used for defining ownership, it is useful to keep in mind as most of the banks in the first two periods – late 1980s and early 1990s were in the first category – political banks. Though it is difficult to state categorically, the table attempts to define which banks can be considered political banks in the next two periods based on information from interviews and newspaper articles.

Table 17: Failure of Banks and NBFIs in Kenya 1984 – 2005

Period	Institution
1984-9	<ul style="list-style-type: none"> Rural Urban Credit Finance (African) Continental Bank, Continental Finance (African) Union Bank, Jimba Credit Corporation (African) Estate Finance, Estate Building Society (African) Business Finance (African) Nationwide Finance (African) Kenya Savings and Mortgages (African) Home Savings and Mortgages (African) Citizens Building Society (African)
1993-5	<ul style="list-style-type: none"> International Finance Company (African) Trade Bank, Trade Finance, Diners Finance (Asian-African and African) Pan African Bank, Pan African Credit Finance (Asian-African and African) Exchange Bank (Asian-African and African) Post Bank Credit (Government owned) Thabiti Finance (African) Export Bank (African) Allied Credit (African) United Trustee Finance (African) Inter-African Credit Finance (African) Middle Africa Finance (African) Nairobi Finance Corporation (African) Central Finance Kenya (African) United Bank (African) Heritage Bank (African) Meridien BIAO Kenya (Foreign owned)
1998	<ul style="list-style-type: none"> Bullion Bank, Fortune Finance (independent Asian-African) Trust Bank (political Asian-African) City Finance Bank (political Asian-African) Reliance Bank (independent Asian-African) Prudential Bank (political African)

Period	Institution
2000-5	<ul style="list-style-type: none"> • Glad-Ak Finance (independent Asian-African) • Delphis Bank (political Asian-African) • Euro Bank (political African) • Daima Bank (political African) • Prudential Building Society (political African)

Source: Brownbridge (1998b) and newspaper articles (various) and interviews

Notes:-

- 1) Includes banks and NBFIs and building societies placed under statutory management by the CBK.
- 2) Financial institutions listed on the same line share common ownership.
- 3) Central Bank of Kenya Annual Reports in the section on banking structure developments do not give the name of the financial institutions that have been placed under statutory management and liquidation but just the number of institutions. Therefore the author had to rely on newspaper articles to establish the names of failed banks.
- 4) Glad-Ak Finance was not put under statutory management but undertook voluntary liquidation.

Technically there are two stages of 'failure'. First is when the CBK imposes 'statutory management' on a bank. This should be done when banks are illiquid but still solvent. Deposits are frozen allowing the bank time to recapitalize. If recapitalization is not possible the bank is then put under 'liquidation'. Liquidation is carried out in Kenya under the Deposit Protection Fund Board (DPFB) which is an independent body but housed and staffed by the CBK. The CBK is not consistent in its reports and in some cases refers the first stage as 'failure' and in others, the second stage as failure. For example, both Euro Bank and Daima Bank were placed under statutory management in 2003. However, in the Central Bank of Kenya Supervision Report of 2004, Daima Bank is still listed as an operating bank. In practice, banks are not put under statutory management until they are almost insolvent. Therefore, in the table above, a bank is listed as failed when it is placed under statutory management.

Of the banks placed under statutory management in Kenya, very few have been restructured successfully. Most of the banks have then been placed under liquidation. The exceptions to this are Trust Bank, City Finance Bank, Bullion Bank (all placed under statutory management in 1998) and Delphis Bank (placed under statutory management in 2001). Trust Bank reopened in August 1999, Bullion Bank in January 2000 while City Finance Bank reopened in April 2000 and Delphis Bank reopened in December 2002. The restructuring model used entailed capitalising the banks by conversion of deposits to equity which enabled the depositors to become major shareholders and control the new banks. Unfortunately the non-performing loan portfolio of Trust Bank was so large that it was not able to survive on re-opening and was put under liquidation by the CBK in 2001.

As said in Chapter 1, we had highlighted the costs of bank failures in SSA.¹²³ There is no doubt that bank failures in Kenya have been very costly to the economy. An addendum to the CBK's 1992/3 Annual Report indicated that the CBK was owed almost KShs. 17.8 bn (around 17% of the total liabilities of the commercial banks) from the overdrawn accounts of three of the commercial banks that were later placed under liquidation. The CBK's provision of overdrafts to the political banks was a major cause of the loss of monetary control and consequent inflation which occurred in 1992/3 (Brownbridge, 1998b). With specific reference to depositors, it has been estimated that the banks that closed in 1993/4 are likely to have accounted for 10% of total deposits in the banking system (Brownbridge and Harvey 1998). When Trust Bank closed in 1998, it was the sixth largest bank in Kenya with total deposits of KShs. 9.1bn (KPMG, 1999). The five banks that closed in 1998 had estimated total deposits of KShs. 25bn (Kyendo, 1999). We have estimated that this represents approximately 9% of total deposits in the banking system in 1997.¹²⁴ Euro Bank, which closed in 2003, had large parastatal deposits and the loss of these deposits was particularly costly to the government and in turn taxpayers.¹²⁵

¹²³ Refer to Chapter 1 and Appendix 1 for an estimate of the cost of bank failures in Kenya in terms of fiscal cost of recapitalization.

¹²⁴ As discussed in Chapter 1, Central Bank of Kenya supervision reports were only published after the year 2000. The total figure for loans in 1997 is KShs. 206bn (Ndi, 1998). From Figure 2 above, the loan/deposit ratio in 1997 is 75%. Therefore we can estimate that total deposits in 1997 were KShs. 274bn.

¹²⁵ It is estimated that two parastatals that are in providing a social safety net for the poor in Kenya – the National Hospital Insurance Fund and the National Social Security Fund had deposited KShs. 490 million and KShs. 250 million in Euro Bank respectively (Kumba, 2008).

As said above, financial liberalization was supposed to increase savings, deposits, credit and in turn economic growth. The main purpose of this section was to show that despite the experience with financial liberalization and changes in regulation, the banking sector in Kenya remains shallow and fragile.

4.4 Studies of the Banking Sector in Kenya

Having considered the historical and structural features of the banking system in Kenya, we now critically assess the studies that have attempted to understand these features.

4.4.1 Studies on the Link between Finance and Growth in Kenya

With reference to the debate on the link between finance and growth, empirical studies similar to the Africa wide studies discussed in Chapter 3 have also been carried out on a country specific basis for Kenya. These studies test the McKinnon-Shaw hypothesis and measure the impact of an increase in real interest rates on savings. Three early studies on Kenya, examining the period 1967 to the end of the 1980s, found that savings were not responsive to real interest rate increases and therefore concluded that financial development did not have a direct impact on growth (Kariuki, 1995; Mwega et al., 1990; Oshikoya, 1992).¹²⁶

The Kariuki (1995) paper is useful as it highlights that there are several *social* factors that also influence savings including size and structure of the family, dependency ratios, life expectancy, education and the presence of the large informal financial sector, as we will show in Chapter 6 social factors are key in understanding the sources of segmentation of the banking sector in Kenya.

Though there is a dissenter: Azam (1996) argues that if savings are measured in terms of national saving and not private saving, and if one controls for external shocks and uses the square of the real interest rate as a proxy of level of financial repression, then there

¹²⁶ All the studies estimate a money demand model. Mwega *et al.* (1990) focuses on the period 1966-1985 and uses data for both M2 and M3. Oshikoya (1992) focuses on a longer period 1970 – 1989 but only uses data for M2. Kariuki (1995) estimates the regression using data from 1968-1990 for M2 and 1973-1990 for M3.

is a positive and significant relationship between the real interest rate and national savings in Kenya during the period 1967-1990. There is however a theoretical contradiction in Azam's argument - one of the key propositions of the McKinnon-Shaw model is that an increase in interest rates should lead to better resource allocation due to an increase *private* sector participation in the financial sector and reduction in government involvement.¹²⁷ Therefore the logic of using increases in national savings rather private savings as a measure of the effectiveness of interest rate increases is not clear.

Studies on the link between finance and growth using data of the 1990s are similarly non-conclusive. Odhiambo (2008) uses a tri-variate causality model to understand the links between financial development and growth using savings as an intermitting variable for the period 1991 - 2005. This case can be seen as a genuine improvement on studies that simply measure the impact of financial development on growth. The paper uses a Granger causality error-correction model where financial deepening is measured in terms of M2/GDP.¹²⁸ The paper finds:

“the empirical results of this study reveal that there is a distinct *uni-directional causal* flow from economic growth to financial development. The results also reveal that economic growth Granger causes savings, while savings drive the development of the financial sector in Kenya. The study, therefore, *warns* that any argument that financial development unambiguously leads to economic growth should be treated with extreme caution.”

Odhiambo (2008 pp., 302)

Odhiambo (2009) uses a bi-variate causality model to understand the links between financial development and growth, therefore compared to Odhiambo (2008), savings is not used as an intermitting variable. The period under consideration is longer – from 1968 to 2004, but like Odhiambo (2008), it still uses a Granger causality error-correction model where financial deepening is measured in terms of M2/GDP.

Odhiambo (2009) provides a conclusion that is opposite to that of Odhiambo (2008) and argues:

¹²⁷ Refer to discussions on the McKinnon-Shaw model discussed in Chapter 2 and Chapter 3.

¹²⁸ Though not explicit in the paper the figure used for savings ratio is 24% in 2005, and therefore the total savings ratio, not just the private savings ratio.

“that by and large the *finance-led* growth causality predominates in Kenya. Although there is evidence of weak bi-directional relationship between financial depth and economic growth, the causal link from finance to growth seems to override the causal link from growth to finance.”

Odhiambo (2009 pp., 311)

The various criticisms discussed in Chapters 2 and 3 of similar studies, in particular their inability to explicitly consider the changes in the structure of the economy as it passes through different stages of development and also the closed system nature of the studies, also apply to these Kenya specific studies.

However the two papers by Odhiambo also reinforce the other core argument of Chapter 3 - the domination and misuse of mainstream methods in the work on finance in SSA. Both studies are by the *same* author, reach completely contrasting conclusions, and yet make no attempt to reconcile these conflicting results.¹²⁹

Methodologically, these studies highlight the need to move away from econometric studies that attempt to prove or disprove the link between finance and growth – either view is simple to prove or disprove. There is a need for studies that attempt to understand the constraints faced by the banking sector when carrying out its functions at a country specific level and this thesis attempts to fill this gap.

4.4.2 Studies on the Impact of Financial Liberalization in Kenya

Even mainstream economists accept that liberalization did not achieve its stated objectives particularly in terms of resource mobilization. However, in line with other mainstream economists in SSA, Ngugi (2000) views this failure of liberalization purely in terms of poor sequencing. It is argued:

“The sequencing of events in the financial sector, however, seemed to miss the set of *preconditions* – for example, interest rate liberalization was

¹²⁹ The papers are not working papers and both papers are published in separate peer-reviewed journals. The 2009 paper does not quote the 2008 paper but the corresponding address of the author on both papers is exactly the same.

accomplished before a *sound and credible banking system* was achieved. Credit controls were relaxed and open market operations initiated when the financial sector was facing excess liquidity...”

Ngugi (2000 pp., 70)¹³⁰

As said in Chapter 3, it is only post liberalization that mainstream literature has begun to emphasize the importance of ‘preconditions’. As the quote above highlights, there is little acknowledgement that liberalization of interest rates was seen as the key to establish a *sound and credible banking system*. As discussed above the banking system prior to liberalization was very fragile and even a casual observer could have recognized this. The paper concludes that there is a need to ‘strengthen the institutional base’ but there is little discussion on what is meant by this in the specific context of the Kenyan banking sector.

4.4.3 Studies on the Market Structure and Competition in Banks in Kenya

In line with other studies discussed in Chapter 3, there are also studies based on the Kenyan banking sector that attempt to measure concentration using somewhat more sophisticated measures. Kamau et al (2004) construct the Hirschman-Herfindall Index (HHI) to measure contestability and concentration ratios and conclude that the Kenyan banking sector is characterized by oligopolistic market structure. This leads to a policy conclusion that minimum capital standards should be reduced to a “reasonable” level to increase competition (A. Kamau, Karingi, Ndung'u, & Mwaura, 2004 pp., 36).¹³¹ They reach this conclusion despite acknowledging that capital requirements are necessary for the stability of the banking system and that:

“..most banks that fall under the category of under-capitalisation are the ones that eventually collapse”

Kamau *et al.* (2004 pp., 34)

¹³⁰ Emphasis added.

¹³¹ They argue that “since banks that had initially met the capital requirements had effective increase in capital [after regulation was put in place to increase minimum], it is a fair assumption that reduction in capital requirements would lead to effective increase in capital and a more competitive banking system” (A. Kamau et al., 2004 pp., 36). We would like to contend that this is not a consistent argument.

Similarly, Kirkpatrick and Kagira (2001) argue that the CBK policy from 1999 onwards of encouraging bank mergers and consolidation while useful in preventing bank failures is leading to an oligopolistic market structure that will in turn exacerbate the problem of access to finance.

As discussed in Chapter 3, these studies on the banking sector in Kenya apply the S-C-P paradigm in a very deficient way by simply assuming that high concentration leads to lower competition. It is also very simplistic to assume that the only barriers to competition are minimum capital requirements. As stated earlier and discussed towards the end of this chapter and throughout this thesis, unless studies take into account the segmentation in the market, they cannot truly address why these concentration ratios persist. Furthermore, there needs to be an acknowledgement that the instability caused by segmentation has an impact on competition that cannot be captured by concentration ratios or contestability indices. Barriers to entry need to be viewed in an extremely nuanced way including barriers to entry caused by social factors and the reputation of banks.

4.4.4 Studies on Interest Rate Spreads in Kenya

There have been several econometric papers attempting to understand the causes of the increased interest rate spread in Kenya (Ndung'u & Ngugi, 2000; Ngugi, 2001, 2004; Ngugi & Kabubo, 1998). For the purposes of this thesis we discuss the last of these papers - Ngugi (2004) - which builds on the other papers, and uses national level time series data from 1991-1999 and bank level panel data from 1998-2002. Several independent variables are posited to have an impact on interest rate spreads and are used as independent variables in the regression analysis. These are default risk (measured as non-performing loans ratio), capital ratio (total equity to total assets), liquidity risk (short term assets to total deposits), cost ratio (operating costs to total loans cost), bank size (total fixed assets to total assets), market concentration, diversification ratio (loans over total assets), management quality (measured as non-interest earning assets over total assets), interest rate volatility, treasury bill rate and inflation.

Several general criticisms can be raised here and the methodological points raised in Chapter 3 in particular the 'pick and mix approach' of using several explanatory variables applies to this study as well.

More specifically, it is not surprising the only variable that is significant in all the regression specifications is non-performing loans. It is argued:

“wide interest spread is sustained by inefficiency in the credit market. For example, high non-performing loans signal high credit risk to which the banks respond by charging a premium, and this keeps the lending rates high”

Ngugi (2004 pp., 27)

However, it has to be recognized that theoretically it is very difficult to specify the direction of causality between interest rate spreads and non-performing loans or specify irrefutably which one should be the independent variable and which one should be the explanatory variable. The two factors are very inter-linked – non-performing loans may *cause* high interest rate spreads as banks build the higher default rates into their costs, but non-performing loans can also be the *result* of high spreads interest rate volatility as borrowers may not have anticipated the increased costs of servicing loans. Therefore these results may merely be capturing the correlation observed – high spreads and high non-performing loans rather than the direction of causality. Yet, there is no acknowledgement of this in the paper.

Secondly, it is surprising that the extremely high and volatile treasury bill rates post liberalization, which are widely believed to have led to increased spreads and to crowding out of lending to the private sector (Buchs & Mathisen, 2005), are found to be either insignificant or negative in regression results.¹³² There is no clear discussion or explanation for this unlikely result in this paper. Elsewhere it has been argued that the fall in spreads from 2003 onwards was due to a reduction in the volume of borrowing by the government, the subsequent reduction in the treasury bill rate and the reduction in the regulatory cash reserve ratio to be maintained by banks with the CBK from 10% to 8% (Cull et al., 2008).

Thirdly, in some specifications of the regression, the capital ratio is found to be a significant determinant of interest rate spreads. The paper argues that the reason for this is that higher capital ratio leads to higher spreads as it is an implicit cost for the bank.

¹³² As said above, high and volatile interest rates can cause higher rates of default.

Again, theoretical basis of this explanation is not clear. It can equally be argued that well capitalized banks can be reasonably assumed to be more cautious lenders and therefore have lower non-performing loans and in turn spreads. The correlation between capital ratio and non-performing loans is not given in the paper to allow the reader to make a judgement on this.

Fourthly, the paper measures management quality in terms of non-interest earning assets to total assets. However, as discussed in the criticisms of development envelope analysis models in Chapter 3, it is not clear that this is an appropriate measure. The decision not to give a loan may also be a good decision for the bank if the loan turns out to be non-performing. Therefore levels of non-interest earning assets are not good indicators of poor performance.

Finally, the paper concludes by highlighting the need improve inefficiency in the credit market through:

“ensuring enforcement of financial contracts and also by individual banks
building information capital and enhancing management quality”

Ngugi (2004 pp., 27)

However, besides pointing to the unfavourable legal environment that makes contract enforcement difficult, there is very little analysis as to why loans go bad in the first place or what is meant by ‘information capital’ in the context of the banking sector in Kenya. This thesis in Chapter 6 attempts to understand how banks in the different segments get and use information and how they are attempting to improve their lending capacity in practice.

4.4.5 Studies on Non-Performing Loans in Kenya

Besides Ngugi (2000) discussed above, there are very few studies that attempt to understand the causes of NPLs in detail. Furthermore, this gross figure masks the differences in NPLs between the segments of the banking sector. The high levels of NPLs in the government owned banks and government owned development finance institutions due to political pressure to extend loans to politically connected figures has been widely discussed in the literature (Brownbridge, 1998b; Njenga, Ngugi, & Mwaura,

2006).¹³³ However, there is little discussion on the reasons for NPLs in local privately owned banks and this thesis aims to fill this gap. Trust Bank, a LPOB, which closed in 1998 had total loan portfolio of KShs. 10 billion of which non-performing loans formed KShs. 5.2 billion, that is about 50% (KPMG, 1999).

4.4.6 Studies on Bank Failures in Kenya

Studies on bank failures have mainly focussed on the first two periods – the 1980s and early 1990s. As said above banks that failed in the first two periods can be categorized as political banks. There was an overlay between the ability of political banks to source public sector deposits cheaply and their ability to circumvent regulations in particular on capital regulations (Brownbridge, 1998b; Kagira & Kirkpatrick, 2001).¹³⁴ This in turn influenced the lending decisions of political banks and there was a high prevalence of insider lending to directors which resulted in high levels of non-performing loans (Brownbridge, 1998b; Kagira & Kirkpatrick, 2001). For example:

“In one case of a grossly undercapitalized bank, the total share capital was KShs. 20.4 million, but the actual paid up capital was only KShs. 2.5 million. The balance of equity contribution was in the form of revaluation of assets....particularly significant was that a good proportion of the bad loans were made to directors, shareholders and their relatives...in one glaring incident, the loans to directors accounted for 30% of the institutions deposits”

Nasibi (1992 pp., 451)¹³⁵

Loopholes in the regulatory framework, including the ability of banks to continue accruing interest on non-performing loans, and the revaluation of assets to hide capital shortfalls have also been identified as causes of bank failures (Kagira & Kirkpatrick, 2001). Though many of these loopholes have now been closed, there still remain doubts on supervisory capacity of the CBK and lack of clarity on the circumstances in which the CBK should intervene in the case of a failing bank (Alawode, 2003).

¹³³ See discussion below on the NPLs levels for government owned banks from 2000-2005.

¹³⁴ As said above, Section 53 of the Banking Act allowed the Minister of Finance to grant exemptions to the Banking Act.

¹³⁵ Unfortunately, the author does not specify which bank is being discussed.

The failure of Meridien-BIAO Kenya can be traced to the collapse of its parent bank, Meridien International Bank Ltd, a Pan-African bank. Meridien-BIAO was formed when a Zambian banker bought Banque de l'Afrique Occidentale (BAO) a francophone West African bank originally set by the French colonial authorities in 1901. Its collapse can be attributed to extremely aggressive lending and mismanagement (Honohan & Beck, 2007). The operations of Meridien-BIAO were relatively small compared to the size of the Kenyan banking market. However the collapse led to systemic crises in Zambia, Cameroon, Swaziland and Central African Republic (Lindgren, 2007; Maimbo, 2002).

One of the key reasons for failure of banks in the 1980s was the shift of parastatal deposits away from NBFIs. It has been shown that in 1982, NBFIs captured 80% of all new parastatal deposits, but by 1986, parastatals had shifted all their deposits away from NBFIs (Ndii, 1998). Brownbridge (1998b) hints on ethno-political dimension of bank failures in the 1980s:

“there is a belief among some members of the banking community in Kenya that some of the locally owned financial institutions that failed in the 1980s (especially those owned by Kikuyu politicians) were deliberately undermined for political reasons through withdrawal of their parastatal deposits”¹³⁶

Brownbridge (1998b pp., 94)

There have been no papers by economists that have commented on this but some political commentators have recently elaborated on this theme:

“It was not an accident that in 1984 African domestic capital was Kikuyu. Kenyatta’s regime had funneled every opportunity that way, and its *backlash* was the equally wrong programme to break it, pursued by the Moi regime...specifically between 1984-1989 the pillar of private African Kenya capital was broken...All this was done by our own Government, because this government considered 1) the creation and possession of wealth by

¹³⁶ As said above, the first President of Kenya was President Kenyatta who was from the Kikuyu ethnic group. On his death in 1978, he was succeeded by President Moi who was from the Kalenjin community.

other African Kenyans was a threat to its own political control; and 2) because the new domestic capital was Kikuyu”

Nowrojee (2001 pp., 2-5)¹³⁷

We would also like to draw attention to parts of the report on the Goldenberg Affair which shed light on the involvement of political and government figures in the banks that failed between 1993 – 1995 (Bosire Commission Report, 2004). The Goldenberg Affair was a political scandal where the Kenyan government was found to have falsely subsidised exports of gold during the 1990s.¹³⁸ Trade Bank (and its affiliates), Pan African Bank, Exchange Bank and Post Bank Credit were all used as conduits for the transfer of funds in the Goldenberg Affair (Bosire Commission Report, 2004). The Goldenberg Affair was finally uncovered in 1992. The scandal is estimated to have cost Kenya between \$600 million to \$1 billion, some 9 to 16 percent of GDP in 1994 (Warutere, 2005).

There are no academic studies that have attempted to understand the causes of bank failures in the second two periods – 1998 and 2000-2005. Due to data constraints, this thesis does not attempt to understand the causes of banks failures from 1998 - 2005.¹³⁹ However, we can make some initial observations. Banks that failed during this period had both Asian-African and African ownership. Newspaper reports have linked some of the failed banks for example Euro Bank to politicians (Muiruri, 2003). Therefore the reasons for failure can be assumed to be similar to those of other political banks that failed in previous periods including excessive reliance on parastatal deposits. However,

¹³⁷ Nowrojee is a Kenyan lawyer.

¹³⁸ Goldenberg International was set up in 1990 by a business man named Kamlesh Pattni to export gold and diamond jewellery from Kenya in return for a 35% premium on the exchange rate in contrast to the normal premium of 20 percent for exporters. Little or no gold was actually exported; indeed Kenya lacks in the availability of these natural resources. It was a scheme established to round-trip the sale of export dollars to the Central Bank of Kenya (essentially, buy dollars at the official exchange rate, sell them back at a 35 percent premium as “gold exports” and then repeat the process). A Commission of Inquiry into the affair was set up by President Mwai Kibaki in 2003, under the Chairmanship of Justice Bosire, and is commonly known as the ‘Bosire Commission’. The report of the Commission highlighted that the scheme involved political figures at the highest level in the Moi government (Bosire Commission Report, 2004). These figures remain powerful in the both the 2002 and the 2007 Kibaki governments and by 2009, no prosecutions had been made.

¹³⁹ As said in Chapter 1, this author was particularly keen on understanding causes of bank failures in these two periods but was not able to get data on this from the DPF.

several of the banks that failed for example Bullion Bank and Reliance Bank had no obvious political connections. In these cases, CBK reports indicate that these banks failed due to high levels of non-performing loans and excessive insider lending (Central Bank of Kenya, 1998).

The discussion above on the political and ethno-political dimensions of bank failures highlights banking relations are embedded in social and political relations and this is a core concept which is used throughout this thesis. In Chapter 5 we discuss the embeddedness of banking relations in social relations from a theoretical perspective. In Chapter 6 we discuss the interview data which provides evidence for and discusses the impact of this embeddedness on segmentation of the banking sector. Furthermore, in Chapter 6, this thesis attempts to understand the constraints faced by local private owned banks (which are independent of politicians) in making lending decisions. In Chapter 8, this thesis considers the likely impact of corporate governance guidelines in reducing insider lending and improving the general performance of the banking sector in Kenya.

4.4.7 Studies on Ability of Banks to Mobilize Deposits in Kenya

There have been very few studies that attempt to understand the constraints faced by banks when trying to mobilize deposits in Kenya. The only study that mentions that the *reputation* of owners is a problem for local banks when raising deposits is Brownbridge (1998b):

“Because of the perception that they are less secure than larger foreign and government-owned banks, the local financial institutions face much higher deposit costs...The chairman of one of the local banks estimated that his average cost of deposits was around 10 percentage points higher than those of Barclays or Standard Chartered. Competition for deposits among the local financial institutions is strong...”

Brownbridge (1998b pp., 90)

This thesis takes a deeper look at this issue by assessing the impact of segmentation on deposit mobilization. In particular in Chapter 6, it analyzes in depth the constraints faced by local private owned banks when raising deposits.

4.4.8 Studies Considering the Segmentation of the Banking Sector

Understanding segmentation within the formal financial sector has not been the primary focus of any prior study.¹⁴⁰ There are only two studies on the Kenyan banking sector that acknowledge the importance of segmentation in their analysis.

The first study, Brownbridge (1998b), focussed on the impact of government policies on the development of banking in Kenya. In this study it was noted that the Kenyan banking system remains largely oligopolistic with the three large banks – Barclays Bank, Standard Chartered Bank and Kenya Commercial Bank (KCB) operating an informal cartel in setting interest rates and charges. It was recognized that their size, their reputations for deposit safety, their extensive local branch networks and their international links protect these top banks. It is further acknowledged that there was a tendency for local financial institutions to lend to customers who were rejected by more established banks and therefore the borrowers of the local privately owned institutions were less creditworthy and more like to default.¹⁴¹

The same study also recognized many of the strengths of local privately owned banks:

“...many local financial institutions represent genuine i.e. (non-fraudulent) attempts to provide financial services, despite a variety of difficulties related to the adverse selection of their borrowers, the high costs of their deposits because of their lack of sound reputation with depositors, and, in some cases, shortages of skilled and experienced personnel. The local financial institutions that have survived have introduced an element of much needed competition into urban deposit markets...and have also provided much more flexible and quicker services for their customers, especially with regard to decisions on loan applications, than the established banks”

Brownbridge (1998b pp., 91)

¹⁴⁰ As stated in Chapter 1, segmentation between formal and informal finance is well documented (Johnson, 2005; Nissanke & Aryeetey, 1998, 2006). However, very few authors have attempted to understand the segmentation *within* the formal financial sector.

¹⁴¹ Recently KCB has experienced severe level of non-performing loans but has survived due to government support.

The second study is from the mainstream - a World Bank working paper by T. Beck and M. Fuchs looked at structural issues affecting competition and access in the Kenyan financial system (Beck & Fuchs, 2004). It use data collected during the IMF - World Bank Financial Sector Assessment Programme (FSAP) of Kenya.¹⁴² The paper defines and analyzes three segments in the banking sector in Kenya – foreign owned banks, government owned banks and local private owned banks. They decompose the interest rate spread and analyze the structural factors underlying the high spreads and margins for each of the segments.¹⁴³ The methodology of the decomposition is summarized in Appendix 8. The results are displayed in Table 18.

Table 18: Decomposition of Interest Rate Spreads in Kenya (%) 2002

	All Banks	Government owned banks	Local private owned banks	Foreign owned banks
Overhead cost	5.6	4.4	5.3	6.6
Loan loss provisions	2.5	4.9	1.5	1.8
Reserve requirement	0.3	0.3	0.4	0.2
Tax	1.9	2.2	1.6	2.1
Profit margin	4.5	5.2	3.7	4.9
Total spread	14.9	16.9	12.5	15.5

Source: Beck and Fuchs (2004)

This methodology has several weaknesses in particular it assumes that spread has only five components – overhead cost, loan loss provisions, reserve requirements, tax and profit margin. Interest rate spread could be driven by other components including factors such as macroeconomic instability or social factors. In particular the profit

¹⁴² The IMF - World Bank FSAP's involve detailed analysis of individual country's financial systems with the aim of initiating programmes financed by the IMF & World Bank to resolve the weaknesses identified during the FSAP. The IMF & World Bank encourage countries to release the findings of FSAPs and the country reports for some countries are available though their web page <http://www.imf.org/external/np/fsap/fsap.asp>. However, the results for Kenya are not in public domain. T. Beck and M. Fuchs were both part of the World Bank team that carried out the FSAP in Kenya. Therefore this working paper provides extremely interesting results using data that is not widely available.

¹⁴³ As said above, interest rate spread is the difference between the average deposit and lending rates. The overhead cost includes all interest costs related to lending (Beck & Fuchs, 2004).

margin component of the spread is calculated as a residual and therefore may capture other factors.¹⁴⁴

It should be recognized that foreign bank entry was a key component of structural adjustment and financial liberalization policies advocated by the Bretton-Wood institutions. These arguments are reflected in the Beck and Fuchs paper, and they begin their discussion with the statement:

“Cross-country comparisons have shown the benefits of foreign bank ownership for developing countries...they impose competitive pressure on domestic banks, increasing efficiency of financial intermediation”

Beck and Fuchs (2004 pp., 4)¹⁴⁵

As noted above, Kenya was one of the few African countries that did not nationalize all foreign owned banks at the time of independence. Therefore, the Kenyan banking system provides a useful contrast to most other African countries that have undergone financial liberalization. Foreign owned banks have continued to operate at all times in post-independence Kenya and yet the banking sector faces many of structural problems prevalent in banking sectors across Africa. From the decomposition of interest rates exercise detailed in Table 18, it is implicitly acknowledged, that foreign banks *cannot* be termed the *most efficient* as the spread they charge and their profit margin, while lower than government banks is much higher than local banks (Beck & Fuchs, 2004).¹⁴⁶ There is an acknowledgement that foreign bank entry is not a panacea for all the structural problems facing the banking sector (Beck & Fuchs, 2004). This study also adds to the body of research emphasizing the poor record of government owned banks in particular

¹⁴⁴ Though not explicitly clarified in the paper, it should be recognized that this ‘profit margin’ is not equivalent to the return on assets calculated as profits divided by net assets. The return on assets for 2002 was 3% for foreign owned banks, 1 % for local private owned banks and -0.4% for government owned banks (Beck & Fuchs, 2004).

¹⁴⁵ There remains a huge debate on the impact of FOB on credit creation in developing countries (Cull & Martinez Peria, 2007; Demirgüç-Kunt & Levine, 2001; dos Santos, 2007; Haas & Naaborg, 2005; Haber, 2004; Martinez Peria & Mody, 2004).

¹⁴⁶ While mainstream economics generally views high profits as a sign that there is low competition in the industry, in banking it has been recognized that very low profits and low franchise value (Stiglitz et al., 2000) can encourage banks to take excessive risks.

the high level of non-performing loans and loan loss provisions of government owned banks.¹⁴⁷

Overhead costs and loan loss provision form the bulk of the interest spread and the authors argue that these are because of high wage costs and a deficient legal framework (Beck & Fuchs, 2004).

The most important conclusion of the study for this thesis is an explicit acknowledgement that segmentation leads to a higher profit margin for foreign and government banks and that this segmentation is based on *reputation*:

“the limited number of large and strong banks constrains the competitiveness of the Kenyan banking system and has resulted in *market segmentation* due to the limited movement of funds and clients across different subsectors.... There is a *reputational bias* against small banks, since many small banks are fragile and weak. Depositors therefore prefer large foreign or state-owned banks”

Beck & Fuchs (2004 pp., 13)¹⁴⁸

However, there is no further discussion on how local banks can build reputation, or a recognition that reputation is social and non-price factor and therefore methodologically research need to use qualitative data and social and historical analysis to understand it.

4.5 A Deeper Look at Segmentation

This section analyzes the performance of each of the segments of the banking sector in Kenya, and forms the basis of the detailed analysis in Chapter 6 and Chapter 8.

The four segments that are analyzed in this thesis are foreign-owned banks (FOB), the government-owned banks (GOB), large private locally owned banks (LPOB), small & medium private locally owned banks (SPOB). Private owned banks are classified as LPOB (large private owned banks) and SPOB (small private owned banks), on an

¹⁴⁷ For other research emphasizing the poor record of government owned banks throughout SSA see Caprio & Klingebiel (1996), Brownbridge & Harvey (1998) and Honohan & Beck (2007)

¹⁴⁸ Emphasis added.

economic measure – the capital base of the banks. Banks with capital base of KShs. 1 billion (approximately USD 13.8 million) or more are classified as LPOB.¹⁴⁹

The data set used for this analysis is individual bank balance sheets from 2000 to 2005.¹⁵⁰ This section first looks at the structure of the banking sector in Kenya in 2005. It then discusses the performance of each of the segments and the key structural features.

4.5.1 Structure of the Banking Sector 2005

Table 19 below shows the structure of the Kenyan banking sector in 2005 in terms of asset size of each bank and also ownership.

Table 19 : Summary Structure of Banking Industry in 2005

	Bank	Segment	Total Assets 2005 Kshs. Million	Market Share	Shareholder Details	Ethnicity Of Ownership
1	Barclays Bank of Kenya	FOB	104,522	16.5%	Barclays Bank Plc Ltd (majority)	Not relevant
2	Standard Chartered Bank	FOB	72,842	11.5%	Standard Chartered Bank Plc (majority)	Not relevant
3	Citibank N.A.	FOB	30,928	4.9%	branch of Citibank N.A.	Not relevant
4	Stanbic Bank	FOB	14,994	2.4%	Standard Bank South Africa	Not relevant
5	Bank of Baroda	FOB	9,265	1.5%	Bank of Baroda India (owned by Government of India)	Indian
6	Bank of India	FOB	7,206	1.1%	branch of Bank of India (owned by Government of India)	Indian
7	Bank of Africa	FOB	5,349	0.8%	Bank of Africa Benin,	Not relevant

¹⁴⁹ This definition is based on convention used by bankers in Kenya. There is no firm rationale for why this has become convention. Capital base refers to total capital (shareholder funds) and not only core capital. Most of the LPOBs have an asset base of more than KShs. 10 billion (approximately USD 139 million at end of 2005 exchange rate) with the exception of Imperial Bank and Trans-National Bank.

¹⁵⁰ While it was possible to get financial data for a few banks before 2000 the data set was very incomplete. Also before 2000 each bank followed different reporting standards and therefore the balance sheets were not comparable. Refer again to discussion on constraints in data collection process in Chapter 1.

	Bank	Segment	Total Assets 2005 Kshs. Million	Market Share	Shareholder Details	Ethnicity Of Ownership
	Kenya				Bank of Africa Madagascar and Netherlands, Development Finance Company	
8	Habib A.G. Zurich	FOB	4,743	0.7%	branch of Habib Bank A.G. Zurich	Pakistani
9	K-Rep Bank	FOB	3,781	0.6%	IFC, NGOs and K-Rep group	Not relevant
10	Habib Bank Ltd	FOB	2,890	0.5%	Aga Khan Fund for Economic Development and Government of Pakistan	Pakistani
11	Kenya Commercial Bank	GOB	78,315	12.3%	Government of Kenya, National Social Security Fund	Not relevant
12	National Bank of Kenya	GOB	32,584	5.1%	Government of Kenya	Not relevant
13	Consolidated Bank	GOB	2,909	0.5%	Government of Kenya	Not relevant
14	Development Bank of Kenya	GOB	2,718	0.4%	Government of Kenya	Not relevant
15	Co-operative Bank of Kenya	LPOB	51,830	8.2%	Over 3000 Co-operative Societies	Not relevant
16	CFC Bank	LPOB	33,112	5.2%	Mr. Jani, Mr. Njonjo, Mr. Kirenje, Mr. Kulei (through holding companies)	Asian-African and African (Kikuyu and Kalenjin)
17	Commercial Bank of Africa	LPOB	29,539	4.7%	Kenyatta family, Rai family and Naushad Merali family	Asian-African and African (Kikuyu)
18	NIC Bank	LPOB	20,585	3.2%	Ndegwa family	African (Kikuyu)
19	I&M Bank	LPOB	18,046	2.8%	S. Raja family	Asian-African
20	Diamond Trust	LPOB	16,384	2.6%	Aga Khan Fund for Economic Development, Allied Irish Bank	Asian-African
21	Equity Bank	LPOB	11,457	1.8%	Britac Insurance Co, IFC, James Mwangi	African (Kikuyu)
22	EABS Bank	SPOB	8,856	1.4%	Pandit Family	Asian-African
23	Fina Bank	SPOB	8,615	1.4%	D. Chandaria family, Patel ("Sparrow") family	Asian-African
24	Imperial Bank	SPOB	7,773	1.2%	Popat Family, Shah (Rex Motors) family, Somji (Freight Forwarders family)	Asian-African
25	Prime Bank	SPOB	7,154	1.1%	A. Kantaria family	Asian-African
26	ABC Bank	SPOB	5,145	0.8%	A. Savani family	Asian-African

	Bank	Segment	Total Assets 2005 Kshs. Million	Market Share	Shareholder Details	Ethnicity Of Ownership
27	Giro Commercial Bank	SPOB	4,905	0.8%	P. Gidoomal family	Asian-African
28	Guardian Bank	SPOB	4,451	0.7%	M. Chandaria family	Asian-African
29	Southern Credit Bank	SPOB	4,221	0.7%	A. Kurji family and several minority shareholders from merger with Bullion Bank	Asian-African
30	Charterhouse Bank Ltd.	SPOB	4,221	0.7%	Shah (Kingsway) family, Ehsani family, Shah (Nakumatt) family, Harun Mwau	Asian-African and African (Kamba)
31	Victoria Commercial Bank	SPOB	4,212	0.7%	Y. Pattni Family	Asian-African
32	Middle East Bank	SPOB	4,051	0.6%	Esmail family, Biwott family, Banque Belgolaise	Asian-African and African (Kalenjin)
33	Equatorial Commercial Bank	SPOB	3,671	0.6%	Naushad Merali family and Gideon Moi family	Asian-African and African (Kalenjin)
34	Credit Bank	SPOB	2,798	0.4%	Simeon Nyachae family	African (Kisii)
35	Chase Bank	SPOB	2,601	0.4%	Alibhai Shariff family, Azim Virjee family, Vohra family	Asian-African
36	Trans-National Bank	LPOB	2,024	0.3%	Mr. Gideon Moi, Mr. Kulei, Mr. Biwott	African (Kalenjin)
37	Fidelity Commercial Bank	SPOB	1,666	0.3%	Sultan Khimji, Murli Sadwani, Bharat Thakrar, Equity Investments, Firoz Manji and N. P. Sheth and 21 other shareholders	Asian-African
38	Paramount Universal Bank	SPOB	1,491	0.2%	Merali and Dodhia families.	Asian-African
39	Oriental Commercial Bank (formerly Delphis Bank)	SPOB	1,376	0.2%	depositors became owners after restructuring	Asian-African
40	Dubai Bank (formerly Mashreq Bank)	SPOB	1,153	0.2%	Zubedi family	Arab (Swahili)
41	City Finance Bank	SPOB	510	0.1%	depositors became owners after restructuring	Asian-African
			634,893	100%		

Source: Author's calculations

Notes:-

- 1) Data in this table is from personal knowledge of the banking sector and interviews with key players in the banking sector.
- 2) Some details of ownership of banks by political elites have been garnered from the 'Kroll Report' (Kroll Associates, 2007).¹⁵¹
- 3) The CMA guidelines on corporate governance published in 2002, section 2.1.3 recommend that the top ten shareholders of publicly listed company should be published in the annual report (Capital Markets Authority, 2002) and therefore details on publicly quoted banks was obtained from their annual reports.¹⁵²
- 4) However, this rule is not part of the Central Bank of Kenya Corporate Guidelines of 2006 and in general, privately held banks do not publish shareholder information in their annual report.¹⁵³

The table raises several interesting features of ownership banking sector in Kenya. The table shows that the first three banks to be established in Kenya – Barclays Bank, Standard Chartered and Kenya Commercial Bank (formed from National Grindlays Bank) remain the three largest banks by asset size in Kenya in 2005 controlling 40.3% of total assets. In Chapter 6 we discuss the segmentation of the banking sector and in particular social factors, which influence the reputation of banks. This segmentation is key to understanding the dominance of these three banks. Figure 9 shows the stark contrast in terms of market share and number of the banks in the different segments. In the FOB segment, there are ten banks controlling 40.4% of the market share. Even within the FOB segment there are differences with the three main banks – Barclays Bank, Standard Chartered Bank and Citibank – controlling 32.9% of the total market.¹⁵⁴ Whereas in the SPOB segment, there are eighteen banks controlling 11.2% of the market. This stark difference means that simple S-C-P analysis described above reveals

¹⁵¹ This is a report that was prepared by a special investigations company – Kroll Associates and commissioned by the former Permanent Secretary for Transparency in Kenya, John Githongo in 2002. The report has not been officially disseminated but is available on the web and was released unofficially through the Kenyan press in 2007.

¹⁵² CMA is the Capital Markets Authority. It regulates that capital markets in Kenya and has issued corporate governance guidelines for publicly listed companies. Therefore publicly quoted banks follow both the CMA guidelines and the CBK guidelines.

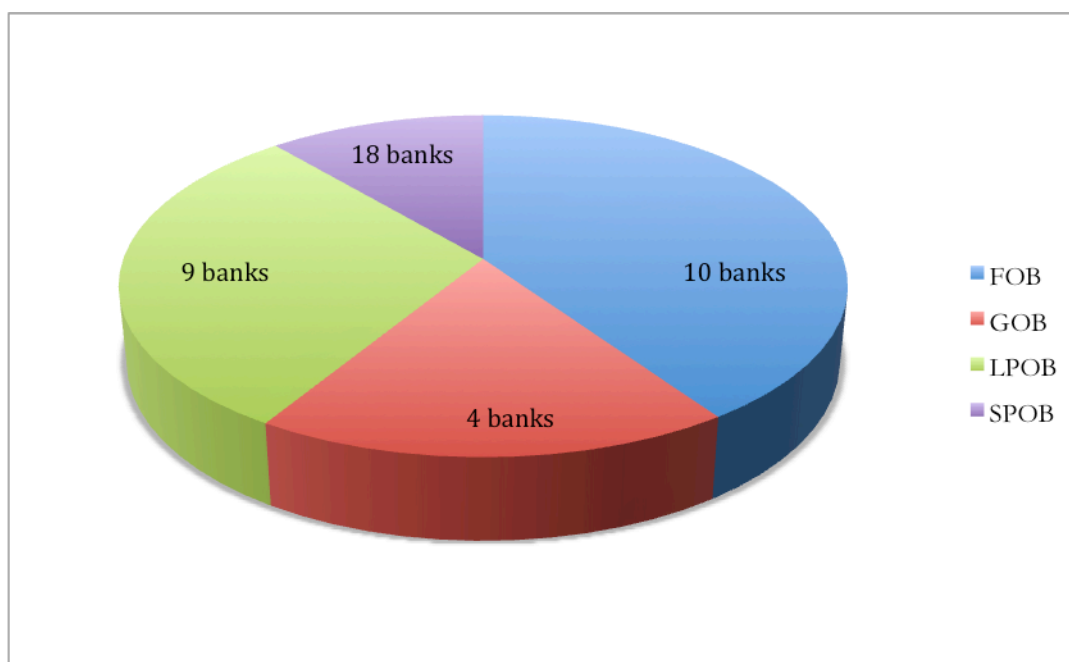
¹⁵³ The exception is Imperial Bank which also published ownership details in its annual report.

¹⁵⁴ The other FOBs are smaller banks serving niche clients.

little about the true nature of competition in the banking sector. We now describe some of their structural features and financial performance of each of the segments.

4.5.2 Financial Data by Segments 2000 - 2005

Figure 9: Market Share by Segment (2005)



Source: Author's calculations

Table 20 shows the change in share of segments between 2000 and 2005.

Table 20: Change in Share of Assets by Segments 2000 - 2005

	Share of Segments 2000	Share of Segments 2005	Total No of Banks in Segment 2005
FOB	43.6%	40.4%	10
GOB	25.5%	18.4%	4
LPOB	19.7%	30.0%	9
SPOB	11.2%	11.2%	18
TOTAL	100%	100.00%	41

Source: Author's calculations

Table 20 shows that the most significant change between 2000 and 2005, is that LPOB have been able to increase their share of the market by over 10%. The FOB and GOB segment have lost market share. Meanwhile, the SPOB have been able to just maintain their market share. Therefore LPOB can be considered to relatively effective in terms

of their competition strategies.¹⁵⁵ Chapter 6 will discuss how some LPOB are successfully overcoming the constraints faced in lending and deposit mobilization.

In Appendix 9 to Appendix 15 we present the data on the financial performance and portfolio characteristics of the different segments of the banking sector in Kenya from 2000 – 2005. The data that is presented is the return on assets, ratio of capital to risk weighted assets, ratio of loans to total assets, ratio of government securities to total loans, total loans on total deposits, non-performing loans and cost of funds.¹⁵⁶ Table 21 provides a summary of the tables in the appendix. Appendix 16 lists the number of branches per bank in 2005 and Appendix 17 the average number of branches per segment. This data is then discussed in relation to each segment below.

Table 21: Financial Performance and Portfolio Characteristics of Segments (Average 2000-2005)

Segment	FOB	GOB	LPOB	SPOB	Total
Return on Assets	3%	1%	3%	0%	1%
Core Capital / Total Risk Weighted Assets	27%	23%	25%	30%	28%
Loans/ Total Assets	40%	53%	50%	52%	49%
Government Securities / Total Loans	117%	26%	38%	31%	53%
Total Loans/ Total Deposits	58%	153%	82%	158%	116%
Total NPL/ Total Loans	9%	46%	16%	28%	22%
Cost of Funds	3%	4%	5%	6%	5%

Source:- Author's calculations

4.5.3 Foreign Owned Banks (FOB) Segment

The origins of the foreign owned banks were discussed above. The three largest banks in the FOB segment are Anglo-American banks. Barclays Bank and Standard Chartered Bank are subsidiaries of banks quoted on the London Stock Exchange. Citibank N.A. operates as a branch of the American global banking giant Citicorp. Stanbic Bank is owned by the South African Banking group Standard Bank. Bank of India and Bank of Baroda are largely owned by Government of India. Habib Bank Ltd is partly owned by

¹⁵⁵ Changes in the market shares of liabilities also follow a similar pattern.

¹⁵⁶ Cost of funds is calculated as interest on customer deposits plus interest on borrowed funds divided by total deposits plus borrowed funds.

the government of Pakistan.¹⁵⁷ Bank of Africa is owned by the Bank of Africa group which is a west-African banking group. K-Rep bank is a micro-finance bank mainly owned by multilateral financial organizations. Barclays Bank and Standard Chartered Bank have amongst the largest branch networks with 49 and 31 branches respectively. They have also been the first to introduce Automated Teller Machines (ATMs) in Kenya. A key measure of profitability of banks is the return on assets (ROA). Generally ROA in Kenya is high compared to other regions. ROA from 2000 – 2004 was 0.6% in the rest of the world (Honohan & Beck, 2007). The table above shows that at 3%, the ROA of the FOB segment is the highest. Within the FOB the three largest banks - Barclays Bank, Standard Chartered Bank Citibank N.A. has extremely high ROA of 5.17%, 4.82%, 4.15%, respectively in 2005. This corroborates the data in Table 18 which showed that the interest rate spreads and profit margins of FOB are the highest. Part of the high profit margin can be explained by the low NPL. In Chapter 6, we discuss the information production mechanisms of FOB to understand this low NPL ratio. While it is difficult to get concrete data on this, it is generally acknowledged that part of the reason for this low NPL ratio is the FOB are able to ‘cream skim’ and get the most credit worth clients in particular large publicly quoted corporations and multinational corporations. They are also conservative with a low loan to deposit ratio and high investment in Treasury Bills. It should be noted that this figure for investment in government securities over total loans is skewed by the extremely high figures for small foreign owned banks – Habib Bank’s ratio in 2005 is 222% and Bank of India’s is 173%. Barclays Bank and Stanbic Bank are less conservative with ratios of 22% and 17% respectively.

A key statistic that is rarely discussed in the literature is the cost of funds. The table above shows that the average cost of funds for FOB segment at 3% is the lowest in the sector. Furthermore the cost of funds for Barclays Bank and Standard Chartered are only 1.03% and 1.67%. In Chapter 6 we show that social factors are essential to understanding the reason for this extremely low cost of funds.

¹⁵⁷ Habib Bank A.G. Zurich was formed by a Pakistani family after the original Habib Bank was nationalized in Pakistan.

4.5.4 Government Owned Banks (GOB) Segment

In Section 4.2.3 we described the establishment of the banks in GOB segment. The two largest government owned banks are Kenya Commercial Bank (KCB) and National Bank of Kenya (NBK) with branch networks of 113 and 24 branches respectively. The poor performance of government owned banks in developing countries due to political loans has been well documented (Beck, Cull, & Jerome, 2005; Brown & Sedar, 2005). The table above corroborates this evidence. The government owned banks have high non-performing loans and very low return on assets. In 2000, the NPL ratio for KCB was 42%, for NBK 70% and for Consolidated Bank 72%. Due to the size of NBK, in 2000, over a third of the total non-performing loans of the entire sector of KShs. 112 billion were held by the National Bank of Kenya (Omondi, 2007b). In an extraordinary move, on 27th November 1998, NBK published the names of their largest borrowers in the national newspapers. It showed that the majority of these non-performing loans were political loans to individual politicians and parastatals. While KCB has been able to reduce the level of NPL to 25% for both NBK and Consolidated Bank the ratio in 2005 is around 45%.

However, the figure which is rarely discussed is that despite these problems, the cost of funds for government owned banks remains much lower than that of the Large and Small Private Owned Banks. In 2005, KCB had a cost of funds of only 0.92%. This is a key source of segmentation in the banking sector and in Chapter 6 we attempt to understand this.

4.5.5 Large Private Owned Banks (LPOB) Segment

Members of two communities in Kenya – the Kikuyu and the Asian-African community own the majority of the privately owned banks. Key political leaders since independence own several banks in the LPOB segment. The Kenyatta family is a shareholder in CBA Bank; the Ndegwa family is a shareholder in NIC Bank; Mr. Njonjo, Mr. Moi and Mr. Kulei are shareholders in CFC Bank; and Mr. Moi, Mr. Kulei and Mr. Biwott are shareholders in Transnational Bank respectively.¹⁵⁸ In terms of innovation each of these

¹⁵⁸ Jomo Kenyatta was the first President of Kenya; Duncan Ndegwa was the first governor of the Central Bank of Kenya; Mr. Njonjo was the first attorney-general of Kenya; Mr. Moi was the second President of Kenya; Mr. Biwott was one of the most powerful ministers in the Moi government; and Mr. Kulei was the personal assistant to Mr. Moi.

banks serves different niches with CBA bank focusing on high net worth individuals, while NIC Bank and CFC Bank focus mainly on asset finance. Equity Bank focuses on micro finance while Co-operative Bank mainly lend Co-operative societies and their members. I&M Bank, Diamond Trust Bank and Imperial Bank are traditionally Asian-African banks which have traditionally focused on trade financing. The LPOBs do not have their own ATM networks but are members of two national ATM networks – Kenswitch and Pesapoint.

The tables show that the LPOBs are able to successfully compete with the FOBs. They have high ROA and fairly low NPL. Furthermore, in terms of intermediation ratios they appear to have struck the right balance between being conservative with a loan/ deposit ratio of 82% but also extending credit with very low investment in Treasury Bills – 38%.

4.5.6 Small Private Owned Banks (SPOB) Segment

The majority of SPOBs are owned by the Asian-African community. They mainly cater to lending to small and medium enterprises from within the community and focus on trade finance and overdraft lending. The other crucial point to note is all the SPOBs meet the basic Basel ratio. The core capital to total risk weighted ratio for this segment is the highest. Yet, the financial ratios show that the performance of this segment is very weak with low ROA and high NPL. It is imperative to note that the cost of funds for this segment is also very high.

We would also like to highlight that table Table 17 above shows that the majority of banks that failed are from the SPOB segment. This is besides Post Bank Credit (which was government-owned) and Meridien BIAO (which was foreign-owned) and Trust Bank which had a capital base of KShs. 1 billion at time of closure and therefore can be classified as a LPOB.

Understanding the constraints that face this segment is key to understanding the sources of segmentation and in Chapter 6 we explain the reasons for these features of the SPOB segment.

4.5.7 Race Relations and Ethnicity in Kenya

Before concluding we would like to discuss briefly the history of race relations in Kenya. Table 19 also lists the ethnicity of the owners of the banks. As we will discuss in Chapter 6, LPOBs and SPOBs where the ownership is Asian-African consider the ethnicity of ownership as a constraint to getting more clients. To understand this perceived negative reputation we now discuss the briefly the context of race relations between Africans and Asian-Africans in Kenya.¹⁵⁹

Above, we discussed the basis settlement of the Asian community in Kenya. It should be recognized that race relations in pre-Independence Kenya were extremely fraught and the colonial government practiced racial discrimination of many forms including the reservation of the best land for Europeans (Patel, 2009; Vandenberg, 2006). The Asian-African community in Kenya in 2005 is a minority with a population of approximately 100,000 individuals within the total population of Kenya estimated at about thirty million. 45 years after independence, most members of the Asian-African community are fourth or fifth generation Kenyans. Yet, members of this community continue to be viewed as outsiders and lived in an atmosphere of partial non-acceptance (Pandurang, 2009). Ali Mazuri has described this negative attitude towards people of Indian origin as 'Indophobia'. He has suggested that this can be examined in two contexts – 'cultural Indophobia' and 'economic Indophobia' (Mazuri, 1976). The first refers to a reaction against Indian cultural habits including food and other social issues including the very low incidence of marriage between Africans and Asian-Africans (Balachandran, 1981; Cable, 1969; Mazuri, 1976). 'Economic Indophobia' refers to the reaction against the economic success of the community (Balachandran, 1981; Mazuri, 1976). Though the economic domination of the Asian-African community has declined considerably since Independence they still remain a very wealthy minority (Vandenberg, 2003).¹⁶⁰

¹⁵⁹ It has to be acknowledged that this short section cannot realistically capture all the complexity and nuances of this deeply emotive topic. Furthermore, it should be acknowledged that the author is a member of the Asian-African community, who has experienced both the prejudice towards Asian-Africans by Africans; the divisions within the Asian-African community that prevents it from presenting a single voice on racial issues; and as secretary of the Asian-African Heritage Exhibition at the National Museums from 2000-2005, has been part of the recent attempts by the community to take stock of the shared past and address hostilities between African and Asian-Africans. However, the author has ensured that the discussion here is based on secondary sources and therefore objective and unbiased.

¹⁶⁰ There was an extremely lively debate, called the 'second Kenya Capital Debate' between Himbara (Himbara, 1994) and Chege (Chege, 1997). This debate attempted to understand level of domination of

On the other side of the equation, the Asian-African community often views itself as 'embattled' and lives with the fear that citizenship does not guarantee security (Balachandran, 1981). The post Independence history of Kenya has included incidents of overt anti-Asian sentiment and actions. This includes the 'Africanization' of trade through the Trade Licensing Act in the 1960s and 1970s when several Kenyans of Asian origin were asked to wind up their business (Balachandran, 1981) and, being referred to as 'paper citizens' and being subjected to a debate entitled 'The Asian Question' by populist politicians during the multi-party elections in 1992 and 1997 (Maganda, 2009).¹⁶¹ In 2002, unhappy with the draft constitution prepared by Constitution of Kenya Review Commission, the then Kenyan President Daniel arap Moi denounced its chairperson Yash Pal Ghai, a Kenyan citizen and an Asian-African, as an 'alien' and called for his replacement (Maganda, 2009). Finally, the memory of the overnight expulsion of Asians from Uganda in 1972 remains etched in the collective memory of all Asian-African families.

More recently, there has been a perceptible reduction in anti-Asian rhetoric by politicians during the 2002 and 2007 elections. This can be attributed partly to the more open and democratic nature of these elections; to the increased and more visible participation of members of the Asian-African community in political affairs; and possibly to other efforts by members of the Asian-African community to reflect on their past with scrutiny and to present their heritage in public forums.

As early as 1969, it was acknowledged that the negative attitudes towards Asian-Africans was partly based on the high levels of inequality and poverty in Kenya:

the Kenyan economy by Asian-Africans and the sources of this domination. An excellent summary of this debated is given in Vandenberg (2003) While this is not the main theme of this thesis, we concur with Vandenberg's conclusions. These are that first there is not enough data to firmly assess the level of domination by Asian-Africans of the Kenyan economy as there is not enough data on who controls the services and agriculture sector. More importantly, to the extent that there is domination by Asian-Africans in large scale industry, it can be attributed to three main factors – the tradition of family business and inter-generational transfer of knowledge amongst Asian-Africans, the greater tendency to own businesses as partnerships and higher levels of starting capital (Vandenberg, 2003)

¹⁶¹ The 'Asian Question?' refers to a wide range of remarks by politicians, mainly during campaign speeches before elections, questioning the right of the Asian-African community to remain in Kenya.

“Closer examination would reveal that these accusations are not only unfair and exaggerated but, worse, that they conceal one of the fundamental problems of East African Society, namely stark inequalities....Differences in income and wealth are enormous and conspicuous. There are high, and largely unfulfilled, expectations amongst the vast majority of the educated or semi-educated poor who form the bulk of Kenya’s population”

Cable (1969 pp., 219)

Inequalities in modern day Kenya are based on a variety of complex factors including tribal affiliations and the ethnic based process of capital accumulation, and not only race (Kanyinga, 2000b).¹⁶² But the extremely high levels of inequality and poverty in Kenya means that complete racial harmony between Africans and Asian-Africans remains a distant goal.

The crucial point to draw from this potted history of race relations, in reference to the banking sector in Kenya, is that trust between Africans and Asian-Africans cannot be assumed to simply exist and has an extremely complex and often contradictory social basis.

4.6 Concluding Remarks

The chapter outlined the historical development of banking in Kenya. It has shown that despite policy changes over the years, the banking sector in Kenya remains fragile and shallow. The chapter has shown that in line with other studies on finance in SSA, studies on the Kenyan banking sector are deficient due to their reliance on mainstream methods and methodology.

The chapter showed that the first three banks to be established in Kenya remain dominant even in 2005. Explaining this dominance is key to explaining the fragility and shallowness of the banking sector. Yet, we reject as simplistic the interpretation from S-C-P studies that attribute the poor performance of the Kenyan banking sector to low competition measured using high concentration ratios.

¹⁶² The brief discussion in Chapter 4, Section 4.3.6 on the ethno-political dimensions of bank failures also gives a brief insight into the extremely ethno-political nature of capital accumulation in Kenya since independence.

We argue that understanding the nature of segmentation of the banking sector is key to understanding the performance of the banking sector in Kenya. The chapter provided evidence of the difference in performance between the four segments of the banking sector in Kenya in terms of margins, non-performing loans, ROA and cost of funds. The rest of this thesis analyzes qualitative interview data on lending decisions, deposit raising and governance of banks in Kenya, in an attempt to understand the differences in performance of the segments. It compares the constraints faced by different segments of the banking sector – foreign owned banks, government owned banks, local large private owned bank and local small private owned banks - and shows how this segmentation is embedded in social relations and non-price factors in particular the perceived reputation of banks.

CHAPTER 5 – THEORETICAL CONCEPTS ON LENDING AND DEPOSIT MOBILIZATION RELATIONSHIPS

5.1 Introduction

The aim of this chapter is to discuss the theoretical concepts that are useful in trying to understand the lending relationship and deposit mobilization relationship. This is to set the background for the empirical discussion of lending and deposit mobilization in the banking sector in Kenya in Chapter 6.

In Section 5.2, this chapter discusses theoretical concepts that underpin mainstream analysis of the lending relationship including transaction costs and information asymmetry. Criticisms of these concepts are then discussed. Following a pluralist methodology, in Section 5.3 and Section 5.4, this chapter discusses several theoretical concepts from Post-Keynesian, Marxist and Institutional schools that we regard as more useful in understanding the lending relationship. They are grouped broadly in two categories - knowledge creation and the role of social factors and trust. Section 5.5 goes on to review the rather limited literature on deposit mobilization with Section 5.6 providing the concluding remarks to this chapter.

This chapter provides the theoretical backdrop for Chapter 6, in which we carry out an empirical analysis of lending and deposit mobilization in the banking sector in Kenya.

5.2 The Lending Relationship - Information Asymmetry and Transaction Costs

As said in Chapter 2, contemporary, banking theory has focused on the role of banks based on the functions they fulfill in reducing frictions or transaction costs (Freixas & Rochet, 1997).¹⁶³ Information asymmetry is the key transaction cost that a bank overcomes when fulfilling the intermediation function, and information production is a key function of banks (Bhattacharya & Thakor, 1993).¹⁶⁴

Stiglitz and Weiss (1981), in their seminal work, put information asymmetry at the heart of the lending relationship and incorporated interest rates and default rates into the model. In their model, banks try to maximise their profit by obtaining a margin between the deposit and loan rate. Borrowers try to maximise their profits by their choice of project. Due to information asymmetry, banks are unable to distinguish good borrowers from bad borrowers. Furthermore, due to adverse selection and moral hazard, the normal market clearing system – raising prices, in this case interest rates, does not work.¹⁶⁵ It simply encourages riskier borrowers to apply for loans. Therefore banks operate a rule of thumb keeping interest rates lower than market conditions warrant. The main conclusion from the model is:

“there are no competitive forces leading supply to equal demand, and credit is rationed”

Stiglitz and Weiss (1981 pp., 206)

Caprio et al (1994) and Nisanke and Aryeetey (1998) have extended the Stiglitz and Weiss model and conceptualised a bank's lending decision making process in a risk-return space where there are two assets that a bank can invest in – risky loans and virtually riskless government treasury bills. The level of loans is determined at the point where the bank's loan risk-return frontier is tangential to the indifference curve of the bank's risk preferences. The loan risk-return frontier reflects a bank's perception of the risks of private sector loans and the indifference curve reflects the risk averseness of the

¹⁶³ Refer to discussions on the Arrow-Debreu model in Chapter 2. Also as discussed in Chapters 2 and 3, financial liberalization theory is based on the view that government controls and financial repression are the main friction and source of transaction costs in financial markets.

¹⁶⁴ Refer to Chapter 2 for a discussion on the function of banks as information gatherers and monitors.

¹⁶⁵ Refer to Chapter 2 for definitions of adverse selection and moral hazard.

bank (Nissanke & Aryeetey, 1998).¹⁶⁶ It is hypothesised that several factors that can affect these two curves include net worth of the bank, asset quality, bank's risk assessment ability, loan administration costs, endowment of information capital and policy uncertainty (Nissanke & Aryeetey, 1998). The main insight of the model is its ability to explain why credit did not increase after financial liberalization. After liberalization banks shifted their portfolios towards riskless government securities despite the high rates available on loans leading to a reduction in supply of loans to the private sector (Caprio, 1994; Nissanke & Aryeetey, 1998).

We would like to argue that while these models are useful in explaining why credit rationing can occur, there is still a need to understand the actual process of information production and how banks bridge information asymmetry in a country specific context.¹⁶⁷ Furthermore, viewing the lending relationship as based solely on information asymmetry is too simplistic as will be discussed below.

5.3 The Lending Relationship - Knowledge Creation

An alternative approach to understanding the lending relationship is the concept of knowledge creation during the process of credit creation as discussed by Dow (1998, 2002). Dow, drawing on the works of organization theory, Minsky, Keynes and Shackle, criticizes the extremely simplistic way in which information is understood in the Stiglitz and Weiss model.

Dow argues that the major flaw with the Stiglitz and Weiss model is that its key result is not based on information asymmetry between a bank and a borrower, but two much stronger assumptions. These assumptions are that borrowers have *perfect information* on the risk level of the projects and secondly that borrowers *conceal* from banks the actual risk attached to the project from (Dow, 1998, 2002).¹⁶⁸ These assumptions interact to

¹⁶⁶ Bank's risk is measured in terms of standard deviation that is deviation from the mean. However, in practice most banks are only concerned about negative risk – that is the risk of loss.

¹⁶⁷ Nissanke and Aryeetey (1998) compare loan administration costs between Ghana, Malawi, Nigeria and Tanzania. The loan administration costs are measured using survey data on time spent by loan officers on screening and monitoring. In Chapter 6, we do not try quantify loan administration costs but discuss in depth the specific constraints faced by bankers in the lending process.

¹⁶⁸ Though Greenwald & Stiglitz (1993) recognize that production is a risky process, this is not translated to the formal models where it is assumed that borrowers face quantifiable measurable risk (Dow, 1998).

minimize the importance of borrower's risk and provides an explanation for credit rationing (Dow, 1998). However, organizational theory indicates that borrowers also face uncertainty about project outcomes. Minsky's financial instability hypothesis (Minsky, 1982) has shown the importance of the role of expectations leading to excessive credit growth during an upswing in the business cycle and credit rationing during a downswing. Therefore, both borrowers and lenders can be both over or under optimistic (Dow, 2002).

In the specific context of developing countries, we would like to argue that by disregarding the relevance of borrower's risk, the Stiglitz and Weiss model ignores studies by other mainstream economists who emphasize the high level of systemic risk in developing countries. It is argued that systemic risks arise from externally driven shocks (often due to commodity price fluctuations) and high level of political instability (Adam & O'Connell, 1999; Collier, 2004). We would like to argue that the focus on shocks and in particular, shocks as *external* factors, provides only a limited understanding of the link between finance and development in SSA.¹⁶⁹ However, what we can draw from the mainstream studies that emphasize external shocks is the fact that due to their stage of economic development, developing countries are subject to high levels of volatility and therefore borrowers in developing countries are also unable to make investments with a high level of certainty.

Furthermore, in the Stiglitz and Weiss model it is assumed that *risk* is reducible once the information asymmetry between borrower and lender is bridged. Dow (1998) following Shackle (1972) and Keynes's *Treatise on Probability* (1921 [1973]) argues that most *knowledge* is subject to uncertainty in terms of *unquantifiable* risk.¹⁷⁰ Therefore according to Dow the lending process should be seen as one in which both parties attempt to *acquire or create knowledge* in an uncertain world (Dow, 1998, 2002).

¹⁶⁹ As discussed in Chapter 3, external shocks are only one factor in a broad range of macro-economic factors that affect the link between finance and development.

¹⁷⁰ Shackle (1972) criticized the probabilistic approach to decision making theory, emphasized that firms investments projects are experimental and therefore, there is no 'correct' frequency distribution with which to measure risk. Keynes *Treatise on Probability* (1921 [1973]) emphasized that the range of information captured by frequency distributions is small. In simple terms, the use of probability relies on past events and therefore by its nature, methods that rely on probability cannot capture the future adequately.

Application of this concept of knowledge creation to the context of credit market implies:

“...that it is in the nature of the banks’ and borrowers’ risk assessment processes that a strong element of *judgement* be employed. This is not the result of borrowers’ intentionally concealing information in an opportunistic manner, but rather the nature of the process of knowledge acquisition in an uncertain world.”

Dow (1998 pp., 222)

It should be recognized that some Marxists, without explicitly using the term knowledge creation, acknowledge that the term *knowledge* is more useful than information asymmetry in understanding the financial system. For example in criticizing mainstream understanding of financial systems it is argued:

‘...information [is treated] as an absolute material fact in possession of market agents, rather than as a state of knowledge among market participants that is conditional upon social, political and historical factors’

Aybar and Lapavitsas (2001 pp., 29)

Chapter 6 provides empirical support for the concept of knowledge creation in its discussion on information production and monitoring by banks. It links the risks faced by borrowers to differences in borrower types in each of the segments of the banking sector in Kenya.¹⁷¹

5.4 The Lending Relationship – Social Factors and Trust

The next concept that is useful in understanding lending relationships is the importance of social factors. Sociological theory builds on financial theory and argues that access to credit is not based purely on the net present value of a project and transaction costs (Uzzi, 1999). Rather banking transactions are *embedded* in social relations. Embeddedness, in turn, leads to the development of trust between the borrower and lender and therefore affects access to and the price of the credit (Johnson, 2003; Uzzi, 1999).

¹⁷¹ The concept of knowledge creation to understand the lending relationship also influenced the design of the interview questions.

In this section we discuss several inter-related concepts – the meaning of embeddedness of social relations in lending relations, how embeddedness helps to build trust between the lender and the borrower, the differences between arm's length and embedded relationships, the link between type of relationship and type of information. We also discuss the briefly the debates on the 'radiuses of trust' and also the role of ethnicity as a social factor.

It should be noted that even economists who focus primarily on transaction cost analysis recognize the importance of social factors. Nisanke and Aryeetey (1998) while focussing on transaction costs, are explicit that the residual variation in their results (that is not accounted for transaction, information and default costs) might be explained by social factors. Caprio (1994) highlights that banks in developing countries need to develop 'long term relationships' with their borrowers. However, there is little empirical analysis of what 'long term relationships' mean in practice and how these change over time.

It is also problematic that mainstream theory, because of its grounding in methodological individualism, assumes that the role of social factors will disappear over time as financial markets develop and that arm's length relationships are the ideal form of relationship. Below we discuss in detail the differences between arm's length relationships and embedded relationships and argue that embedded relations also offer significant benefits to both banks and borrowers. Furthermore, as we will show in Chapter 6, the role of social factors in lending relationships remains pervasive, even though the character of embeddedness changes over time. In methodological terms, there is little recognition in mainstream studies that an acknowledgement that banking relations are embedded in social relations necessitates research methodology that enables an understanding of specific historical and social factors affecting a country. Therefore, large cross country studies or simplistic S-C-P or DEA analysis, all of which were discussed in Chapter 3, are inadequate.

The embeddedness argument is based on the work of Granovetter (1985) who argues that:

“the embeddedness argument stresses...the role of concrete personal relations and structures of such relations [social relations] in generating trust and discouraging malfeasance”

Granovetter (1985 pp., 490)

Uzzi defines social embeddedness as:

“the degree to which commercial transactions take place through social relations and networks of relations that use the exchange protocols associated with social, non-commercial attachments to govern business dealings”

Uzzi (1999 pp., 482)

Therefore, in the specific context of lending relationships, social relations allow exchange of knowledge and information and the development of trust between the lender and the borrower.¹⁷² This encourages the lender to disburse the loan to the borrower on a basis that cannot simply be captured by price factors and transaction costs.

The embeddedness approach has been combined with the ‘Real Markets’ approach to understand rural financial markets in Kenya (Johnson, 2003, 2004b, 2004c). ‘Real Markets’ approach views exchange as embedded in social and non-price factors rejecting the methodological individualism of neo-classical economics. It is based on the theoretical insights of ‘old’ institutional economics and treats institutions as central to economic analysis (Johnson, 2003).¹⁷³ This approach is based on the view that a range of

¹⁷² It should be acknowledged that when we use the term trust here we use it in a very narrow context of the relationship between the bank and the borrower. In the specific context of finance, we do not look at the development of trust between banks which is also essential for the smooth functioning of the payment system. Furthermore, while it is not the main focus of this thesis is important to recognize the definition, meaning and the social basis of trust is still a highly debated issue amongst sociologists, anthropologists and political scientists. For a summary of these debates see good summary of the different debates on trust mainly conducted by anthropologists Harriss (2003) and Neve (2005).

¹⁷³ Markets are defined as “a set of social institutions in which a large number of commodity exchanges of a specific type regularly take place and to some extent are facilitated and structured by those institutions” (Hodgson, 1988pp., 176 quoted in Johnson 2003).

institutions from the state to social and economic relations of class, gender, age and ethnicity are important (Johnson, 2003).¹⁷⁴

Johnson (2003) shows that the embeddedness approach combines the transaction cost approach where high interest rates are viewed solely in terms of high transaction costs and political economy analysis of interest rates which emphasizes class relations.¹⁷⁵ Johnson shows that borrowers in the rural parts of central Kenya prefer to borrow from mutually organised financial institutions (savings co-operatives) rather than banks mainly due to a wide range of social, political and cultural reasons (Johnson, 2003, 2004c, 2005). In particular Johnson shows that because land cannot be offered as collateral due to political and cultural reasons, borrowers prefer mutually organised financial institutions (savings co-operatives) that do not demand collateral (Johnson, 2005).¹⁷⁶ The author also shows that gender relations make it more difficult for women to access financial services than men (Johnson, 2005). More generally with reference to rural financial markets and micro-finance in Kenya, it has been shown that a wide range of institutions including social and cultural norms affect economic behaviour and can help to explain the persistence of particular sets of financial arrangements over time even if they do not reduce transaction costs (Johnson, 2003 pp., 300).

The Johnson (2003, 2004c, 2005) studies are part of an increasingly accepted body of knowledge that attempts to understand the impact of social factors on informal and rural markets. Furthermore it is recognized that social and cultural institutions do not only affect the 'informal' sector and stop at the door of the 'formal' financial sector. Formal financial institutions are equally subject to the influence of social and cultural

¹⁷⁴ It should be noted that the 'old institutional economics' can be distinguished from 'new institutional economics' as popularised by Douglass North (North, 1989). The key difference is that while new institutional economics emphasizes the importance of institutions for economic growth, it still focuses on the emergence of institutions out of the interaction of *individuals* assuming an initial institution free stage (Hodgson, 1998). On the other hand, old institutional economics recognizes that while individuals interact to form institutions, they are also moulded by socio-economic conditions (Hodgson, 1998). 'Old' institutionalists emphasize that assuming that 'direction of causality' is from individuals to institutions is misplaced.

¹⁷⁵ Class and power relations have been used to explain how money lenders are able to charge labourers usurious interest rates in rural agricultural economies (Bhaduri, 1977, 1981).

¹⁷⁶ Cultural norms and sanctions that prevent the collateralization of land in Kenya include norms of land inheritance, burial and the gendered incidence of shame (Johnson, 2003). Political factors that prevent the collateralization of land in Kenya are discussed in detail in Chapter 6.

institutions” (Johnson, 2003 pp., 39). Yet, there are very few studies that try to understand how formal markets may also be affected by social factors and this thesis attempts to fill this gap.

An interesting study of the application of the embeddedness approach to formal banking is Uzzi (1999). Using a combination of methods – interviews of bank managers and survey data of 2,400 midmarket firms in the United States – the author tests the impact of arm’s length versus embedded ties between banks and borrowers.¹⁷⁷ Arm’s length ties are defined as ties that are characterized by lean and irregular transactions which function without prolonged human or social contact between parties. The author finds that firms that have embedded social relations rather than arm’s length ties with banks are more likely to get financing at a cheaper interest rate.¹⁷⁸

The channels and reasons for this result are discerned from interviews conducted of relationship managers of banks. The study finds that embedded social ties help to build trust between banks and the borrowers. Not only do the ties help to bridge the basic information asymmetry between the bank and the borrower in terms of the net present value of a project, but they allow bankers to access what Uzzi terms ‘private information’. The paper elaborates:

“Private information...may include, for example, unpublished capabilities in products, the need to source particular material, the strategic blueprints for an executive succession, investment plans, failed solutions, the rollout date of a new product, or critical resource dependencies”

Uzzi (1999 pp., 483)

¹⁷⁷ Midmarket firms are defined as firms with fewer than 500 employees or less than \$500 million in annual sales (Uzzi, 1999)

¹⁷⁸ In the statistical analysis from survey data embedded ties were measured using the duration of the relationship and the multiplexity of the relationship in terms of number of the bank’s services used by the firm (Uzzi, 1999). We would like to argue that while these quantitative measures cannot capture the complexity of social relations, the fact that this study also uses qualitative data to understand the channels through which social relations affect access and price to credit, this study overcomes many of the problems of purely quantitative studies discussed in Chapters 2 and 3.

The key point to note here is, that by its very nature this ‘private information’, or what is usually referred to as ‘soft information’ in the economics literature, it is usually not shared in arm’s length relationships but only in embedded relationships (Uzzi, 1999).

It is also useful at this stage to highlight the link between types of relationship (arm’s length and embedded) to the distinction between ‘hard’ information and ‘soft’ information. We distinguish between hard and soft information based on the terminology used by economists.¹⁷⁹ Hard information consists of firm or project specific financial data from borrowers’ balance sheets and also industrial data. It is already in numerical form therefore easy to quantify, verify and transfer. It is generally cheaper to collect hard information and also compare it. Soft information is qualitative and based on ‘words’ including ideas, opinions and comments. Therefore by its nature it is difficult to quantify and is generated in the specific context of the bank-borrower relationship and its use relies on some level of judgment (C. Chang, Liao, Yu, & Ni, 2009; Godbillon-Camus & Godlewski, 2005). Therefore, impersonal arm’s length relationships rely on hard information to make decisions on lending. Embedded relationships, built through social networks, have access to, and rely more on soft information to make lending decisions.

Furthermore, we would like to emphasize that Uzzi’s argument is more nuanced than simply showing the importance of social relations in lending relations. The paper shows that arm’s length relationships and embedded relationships are *complementary* rather than mutually exclusive and one type of tie helps overcome the limitations of the other type of tie. Therefore a firm that has embedded relationships with a bank is more likely to get funding, but, if it is also able to meet most of the financial criteria, it is also more likely to put in effort to repay the loan (Uzzi, 1999). The corollary is that banks that rely on a mix of arm’s length and embedded ties are likely to have better information production and monitoring of their borrowers.

Furthermore, while the embeddedness thesis emphasizes that social relations are *necessary* to build trust between a bank and a borrower, the thesis explicitly recognizes that social relations are not necessarily *sufficient* to ensure that neither party breaks this trust (Johnson, 2003). As Granovetter highlights:

¹⁷⁹ We found it interesting that during the interview process, bankers do not make a strong distinction between hard and soft information. This is discussed further in Chapter 6.

“since networks of social relations penetrate irregularly and in differing degrees in different sectors of economic life, thus allowing for what we already know: distrust, opportunism and disorder are by no means *absent*”

Granovetter (1992 pp., 62)

In Chapter 6, we provide empirical support the importance of social factors in the lending relationship and, more importantly, we also show that social factors can have both positive and negative impact on the quality of the lending relationship.

At this stage it is also useful to discuss briefly the literature that considers the changes in social basis of trust from personal and familial level to an institutional level. Francis Fukuyama, though not an academic, has been one of the most influential writers who has argued that a society in which trust has spread beyond the narrow circles of family and kin, to more generalized trust in other institutions, economic development has taken off (Fukuyama, 1995). Fukuyama’s core argument which links different ‘radiuses of trust’ to economic development has been widely debated and criticized and it is beyond the scope of this thesis to discuss this debate here.¹⁸⁰ However, there are several anthropological studies that show shifts in business transactions from away from personalized trust. For example, in a historical and ethnographic study of merchant castes in Chennai (Madras), it has been argued that:

‘the high level of trust that went with a community organized and constrained by personalized face-to-face relationships has disappeared. To a considerable extent the need to establish trust through enduring personal ties has been replaced by impersonal contractual relationships, law and governmental bureaucracy’

Mines (1994 pp., 79)

There are two points from this discussion that are relevant for our empirical analysis. First, it is important to recognize that the social basis of trust is constantly changing. In Chapter 6 we find empirical support for the changes in reliance on social factors in the lending relationship. Second, and linked to the segmentation of the banking sector, is to

¹⁸⁰ The term ‘radiuses of trust’ captures Fukuyama’s argument and is used by Harriss (2003) in his discussion on Indian business.

recognize that even within one system, there may be different ‘radiuses of trust’. Therefore while foreign owned banks and government owned banks rely on more formal mechanisms both ex-ante to make credit decisions and ex-post to monitor the loans, private owned banks still rely on personal or social relations.

Finally, it is useful to discuss the role of ethnicity as a social factor on which trust can be based. Harriss (2003) presents a typology used by anthropologists on the social basis of trust that is useful to discuss here. It is suggested that trust can be based on ‘character assessment’ (A trusts B because of who he or she is) or ‘incentive assessment’ (A trusts B because of her assessment of the incentives acting upon the other).¹⁸¹ Character assessment may be ‘specific’, relying on experience of the other or on third-party assessment of her, or ‘generic’, relying on the general reputation of those with her characteristics, or on characteristics that are shared by A and B (for example, they are of the same *ethnicity*). Therefore, shared ethnicity can form a basis of general reputation and trust between two parties.

Brownbridge (1998b) conjectured that banks owned by members of the Asian-African community in Kenya, served mainly members of their own community, and therefore could use community pressure to bear on loan defaulters. In Chapter 6 we discuss the role of ethnicity in building trust between bank and borrower, interrogate how this relationship is different for different segments, consider the impact on the performance of loans when banks rely on ethnic ties to monitor borrowers and finally describe how these relationships are changing over time.

We now discuss the theoretical literature on the relationship between the bank and the depositor.

5.5 The Deposit Mobilization Relationship

Mainstream contemporary banking theory focuses primarily on the relationships between banks and their borrowers, that is, the asset side of a bank’s balance sheet with a focus on information asymmetry as a key transaction cost. The liability side of the

¹⁸¹ Incentives could be non-formal social incentives such as cultural norms of reputation or more formal incentives such as legal institutions.

balance sheet, that is, the relationships between banks and their depositors, has not been analyzed in depth.

There is little guidance from contemporary banking theory on how depositors choose which bank to deposit with. The only significant mainstream theory on deposit mobilization comes from the financial repression school where it is argued that the deposit mobilization by banks would increase once ceilings on interest rates fixed by governments were removed (Fry, 1988).¹⁸²

Banks are viewed as delegated monitors (on behalf of depositors) and it is recognized that the stability of the claims of the depositors depends on the banks ability of monitor borrowers and ensure that their asset portfolio remains sound (Diamond, 1984). Depositors can and should play a role in monitoring of banks, by moving their deposits from banks they consider unsound, but there is little guidance on whether depositors have the capacity to monitor banks and if so how effectively they monitor banks in practice. It has been recognized depositors are prone to cause bank runs due to rumours and panic this may lead to failure of even healthy banks due to a shortage of liquidity (Diamond & Dybvig, 1983).

In general it is assumed that central bank in its capacity as regulator and lender of last resort and some form of deposit insurance, provides the basis for this stability in the relationship between the bank and the depositor (Freixas & Rochet, 1997). It should be recognized there is a huge mainstream literature on deposit insurance. This literature tends to emphasize the negative aspects of deposit insurance in particular the moral hazard issues surrounding deposit insurance. It is argued that the presence of deposit insurance encourages banks to take excessive risk and reduces the incentives of depositors to monitor banks (Demirgüç-Kunt & Detragiache, 1997, 2000). Furthermore, it is argued that deposit insurance schemes only works in countries where there is a 'strong' institutional environment and therefore should only be considered by developing countries once they have stronger institutions (Demirguc-Kunt, Kane, & Laeven, 2008). We would like to argue that there needs to be a move in the research

¹⁸² Refer to Chapter 2 and 3 for the criticisms of the financial repression school.

agenda from understanding the impact of deposit insurance to understanding the reality of how banks mobilize deposits and in Chapter 6 we attempt to understand this.¹⁸³

We now discuss alternative theoretical concepts from heterodox schools that are more useful in understanding the relationship between the bank and the depositor. These concepts form the background of the empirical work on deposit mobilization discussed in Chapter 6.

First, Chick and Dow's Post-Keynesian framework of stages of banking development (Chick, 1992, 1997; Dow et al., 2008) highlights that ability of banks to move from pure intermediation to credit creation requires the ability of banks to win the *confidence* of the public (stage 2 in their framework) and for the central bank to take full responsibility of lender of last resort (stage 4 in their framework) (Ruziev, 2006).¹⁸⁴ Therefore the perceived safety of deposits is key stage in financial development and it underpins the ability of a bank to extend loans.

Second, Lapavitsas, working in a Marxist framework has highlighted the centrality of trust between a bank and a depositor. It is argued that by construction, a bank is unable to meet all its deposit liabilities at once and therefore, trust between a bank and depositor is essential (Lapavitsas, 2007). More importantly Lapavitsas highlights the inter-linkage between the liability and asset side of a banks balance sheet. It is argued that:

“A bank's profits and ability to honour its promises to pay depend overwhelmingly on the validity and prompt repayment of the banks' assets – i.e. on other capitalists' promises to pay. In short, trust in a bank's liabilities derives from the composition and quality of the assets on its balance sheet, which are mostly debts of others”

Lapavitsas (2003)

¹⁸³ Furthermore, while it is not the main subject of this thesis, we would like to argue that there needs to be research into understanding the reasons how depositors make the decision to deposit their savings in a particular bank.

¹⁸⁴ See Chapter 2, Appendix 5 for detailed summary of stages of banking development framework of Chick and Dow.

Therefore, not only are lending relations embedded in social relations as described above, but the ability of banks to raise deposits is also *underpinned* by social relations.

Third, and following on from the discussion above, it has been recognized by institutional economists, that in practice, the quality of a bank's assets is private information and it is not easy for a depositor to judge between a good bank and a bad bank (Johnson, 2004c; Ndii, 1994). The average deposit rate does not contain enough information about the quality of the banks' assets (Johnson, 2004c). In this context banks resort to other techniques to signal the quality of their asset base such as highly liquid asset portfolios and large banking halls and big buildings (Johnson, 2004c). In Chapter 6 we discuss how the social factors including the ethnicity of the owners of banks influence the trust between banks and depositors.

The final concept that is seen to be useful in understanding the relationship between a bank and depositor is from business management literature. This is the concept of the bargaining power of customers as a key force in influencing the nature and degree of competition (Porter, 1979).¹⁸⁵

In Chapter 6, keeping these theoretical concepts in mind, we attempt to show the extremely complex nature of the relationship between a bank and the depositor and how different segments of the banking sector develop the trust of their depositors. These theoretical concepts are extremely useful to understand the banking system in Kenya where the central bank is unable to fully guarantee financial stability and therefore even within 'one' banking system, there can be different 'radiuses of trust' in banks by depositors. Chapter 6 also shows that the bargaining power of customers, in particular depositors, varies across the segments of the banking sector in Kenya.

¹⁸⁵ Porter (1979) stipulated that the nature and degree of competition in an industry hinges primarily on five forces: the threat of new entrants, the bargaining power of customers, the bargaining power of suppliers, the threat of substitute products, and the level of competitive rivalry. As said in Chapter 3, Maimbo (2002) also uses Porter's five forces framework in the context of the banking sector in Zambia and emphasized that excessive price based competition revealed fragility in banking sector before the traditional financial ratios began deteriorating.

5.6 Concluding Remarks

Following a pluralist approach, this chapter discusses several theoretical concepts from heterodox schools that are relevant to understanding the lending and the deposit mobilization process.

In summary, they are, first, Post Keynesian concept of knowledge creation is more useful than information asymmetry to understand the lending process. Second, the process of credit creation is based on trust and credit relations are embedded in social relations. The importance of social factors means that information asymmetry between lenders and borrowers is not based solely on transaction costs but also on historical and social factors means but social factors can have both positive and negative impact on the quality of a banks loan portfolio.

We also discussed the significance of trust between banks and depositors in deposit mobilization. We argued that this depends on the level of economic development and therefore it cannot be simply assumed to exist for developing financial sectors.

These concepts form the background for the empirical discussion of lending and deposit mobilization that are discussed in Chapter 6. These concepts help us get a deeper understanding of the constraints faced by banks in the Kenyan banking sector. In particular Chapter 6 attempts to understand how banks develop trust between themselves and their borrowers and depositors, how social factors affect the development of this trust, and also how the character of this trust is different for different segments of the banking industry.

CHAPTER 6 – BANK LENDING AND DEPOSIT MOBILIZATION: THE EXPERIENCE OF THE BANKING SECTOR IN KENYA

“Small local banks are the best entities for providing financial services to the enterprises and households that are most important in terms of comparative advantage – be they asparagus farmers in Peru, cut-flower companies in Kenya or garment factories in Bangladesh”

Justin Lin, Chief Economist, The World Bank (2009)

6.1 Introduction

It is simple to state that the functions of banks are lending and deposit mobilization. But, when banks do not fulfill these functions effectively, what are the constraints that they face? This chapter discusses the experience of banks in Kenya in carrying out their lending and deposit mobilization functions.¹⁸⁶ It uses the theoretical concepts on lending and deposit mobilization discussed in Chapter 5. The main aim of this chapter is to give a deeper understanding of the structural problems of the banking sector in Kenya and in particular the segmented nature of the banking sector that was highlighted in Chapter 4. This chapter analyzes the data from qualitative semi-structured interviews of banks carried out by the author. The chapter explores the similarities and differences between the four segments that we have identified – Foreign Owned Banks (FOBs), Government Owned Banks (GOBs), local Large Private Owned Banks (LPOBs) and local Small Private Owned Banks (SPOBs) in terms of the lending relationship and the deposit mobilization relationship.

In Section 6.2 we provide a summary of the constraints to lending that were gleaned from the interview data. Section 6.3 discusses the constraints that are well discussed in the literature – that is the economic and legal environment. Section 6.4 discusses constraints to lending that are not discussed in detail in the literature - these are - fluid social factors and the intricacies of inadequate information production and monitoring.

¹⁸⁶ As noted in Chapter 1, this thesis focuses on three relationships in banking – lending, deposit mobilization and corporate governance. This chapter discusses the first two relationships. Refer to the research questions stated in Chapter 1, Section 1.1.3 and 1.1.4.

Section 6.5 discusses the constraints to deposit mobilization faced by different segments of the banking sector. Section 6.6 provides from concluding comments in particular on the implications of our analysis for finance and development.

6.2 Constraints to Lending - Summary

To recap, in Chapter 4 we showed the development of the banking sector in Kenya. We showed that the banking sector as a whole is characterized, by high levels of spreads, high non-performing loans and several bank failures. We highlighted that the top three banks (Barclays Bank, Kenya Commercial Bank and Standard Chartered Bank) control 40.3% of the market in terms of assets. Therefore, in line with mainstream analysis, we do recognize that the market is highly concentrated. However we argued that it is simplistic to link the poor performance of the banking sector to high concentration levels. This thesis argues that to understand the performance of the banking sector in Kenya it is imperative to analyze each of the segments in the banking sector.

In Chapter 4, we showed that there are significant differences between the four segments – FOB, GOB, LPOB and SPOB in terms of performance. FOBs and GOBs banks enjoy higher margins than the LPOB and SPOB. Furthermore, there are significant differences in the NPL ratio of different segments. While high levels of NPLs in GOBs have been well documented in the literature, we showed that SPOBs also had high levels of NPLs. We also showed the cost of funds of SPOB is relatively high. We also showed that LPOBs have been relatively successful in increasing their market share.

Table 22 below summarize the qualitative data gathered in the semi-structured interviews on the constraints on lending and reasons for high NPLs across different segments.¹⁸⁷ The main constraints that were reported in the interviews can be categorized in two groups:

¹⁸⁷ Refer to Chapter 1 for the limitations of data collection and data analysis.

- 1) Economic and Legal environment: These include
 - a. Conditions in the real economy and changes in the economic environment.
 - b. Poor legal system and the inability of banks to recover their collateral.
- 2) Fluid social relations and inadequacy in the information production and monitoring procedures. These include:
 - a. Lack of Credit Registry
 - b. Over reliance on collateral lending
 - c. Over reliance on name lending
 - d. Unreliability of financial accounts
 - e. Lapses in internal control
 - f. Constrained by image as ethnic bank

It should be noted that the existing literature, mainly focuses on the first group of constraints (Beck & Fuchs, 2004; Daumont et al., 2004).¹⁸⁸ The second group of constraint – information production and the impact of social relations on building trust between a bank and borrower – is usually discussed in the literature in very general terms.

The ethnicity of bank ownership is also highlighted in Table 22 as it has a key impact on the lending and deposit mobilization relationships, as will be discussed below. In particular, keeping in mind the discussion on race relations in Chapter 4, the ethnicity of the ownership of the bank has an impact in developing trust between the bank and the borrower and the bank and the depositor.

The interviews revealed that the first group of constraints affect the lending practices and performance of the banks in every segment though with slightly differential impact across segments. The second group of constraints, however, affect mainly the LPOB and SPOB segment and therefore there are significant differences in impact across segments.

¹⁸⁸ See Section 3.7 in Chapter 3 and Sections 4.4.5 and 4.4.6 in Chapter 4.

Table 22: Constraints to Lending and Reasons for High NPLs

	Segment	FOB	GOB	LPOB	SPOB
	No of Banks Interviewed in Segment	1 (Bank 1)	1 (Bank 2)	3 (Bank 3, Bank 4, Bank 5)	2 (Bank 6, Bank 7)
Ethnicity of Ownership of Bank		Not relevant (Foreign Owned)	Not relevant (Governm ent Owned)	1)Kikuyu and Asian-African 2)Kikuyu, Kalenjin and Asian- African 3)Asian-African	Both Asian- African
1	Change in Economic Environment	YES	YES	YES	YES
2	Poor Legal System, Unreliability of collateral	YES	YES	YES	YES
3	Unreliability of Financial Accounts (hard info)	NO	NO	YES	YES
4	Over-reliance on Security Based (Collateral) Lending	NO	NO	YES	YES
5	Over-reliance on Social Factors and 'Name Lending'	NO	NO	YES	YES
6	Unreliability of (change in) Social Factors	NO	NO	YES	YES
7	Lack of Credit Registry	only for retails clients	only for retail clients	only for retails clients	YES
8	Lack of Reference from other Bank	NO, silent network	NO, silent network	YES	YES

	Segment	FOB	GOB	LPOB	SPOB
	No of Banks Interviewed in Segment	1 (Bank 1)	1 (Bank 2)	3 (Bank 3, Bank 4, Bank 5)	2 (Bank 6, Bank 7)
9	Lapse in Internal Control	YES	YES	YES	YES, lack of proper control
10	Restricted by Ethnic Group	NO	NO	NO for Bank 3 and Bank 4. YES for Bank 5	YES

6.3 Constraints to Lending - Economic and Legal Environment

6.3.1 Conditions in the Real Economy and Changes in the Economic Environment

The interviews reveal that conditions in the real economy and changes in economic environment affect lending practices of banks in every segment. There was general agreement that the majority of NPLs occurred from 1997 to 2002 when interest rates in Kenya were very high and economic growth was low and unstable.¹⁸⁹ Furthermore, political instability, which affected certain sectors of the economy such as tourism, also led to high NPLs. A complete loss of market for a clients' product due to structural change in the economy also leads to NPLs.

“Economic downturn was mainly due to fall in tourism, drought and perception of Kenya as a pariah state. 8 years ago we had a large exposure to tourism. The political problems and clashes had a huge negative impact on our portfolio” - Interview Bank 3, LPOB

“For example tourism went through a bad patch” – Interview Bank 6, SPOB

“However in cases where there is a fundamental problem e.g. there is no market for the clients product, then, it is hard to restructure. For example,

¹⁸⁹ Refer to Section 4.2.6 and Section 4.4 in Chapter 4 for details on the economic environment and trends during this period.

one of our clients, a bookstore that had KShs. 40million of stock became worthless when the syllabus changed” Interview Bank 5 – LPOB

“From the point of view of the borrower the main reason for NPLs is lack of structured growth in the economy. Often *their growth projections do not materialize*, as the political environment is so unstable, that economic growth is also unstable. Furthermore our clients often complain about the high and fluctuating interest rates” – Interview Bank 7, SPOB

In summary, conditions in the real economy and changes in these conditions affect *all* segments of the banking sector. However, it is also important to note that changes in the real economy affect the SPOB segment disproportionately due to the nature of their client - the small and medium sized enterprise and in particular, family owned businesses – that are less productive and more fragile.¹⁹⁰ The size of loan is different for each of the segments with the average minimum corporate loan for FOB and GOB being KShs. 20 million, the average for LPOB being KShs. 10 million and for SPOB being KShs. 5 million. While the main corporate client for FOB and GOB are very large corporations including multinationals and companies quoted on the Nairobi Stock Exchange the clients of LPOB and SPOB are small and medium sized enterprises. The SPOBs interviewed stated that the majority of their clients are family owned businesses. It has been shown small and medium sized enterprises in Kenya have much lower labour and total factor productivity rates than larger firms and also much higher failure rates than large firms (Söderbom, 2001).

Furthermore, the responses also highlight that banks recognize that information asymmetry between banks and borrowers does not mainly arise because the borrowers consistently hide information from the bank. Referring again to the quote above there is an appreciation that in some cases borrowers “*growth projections do not materialise*” and that the borrowers themselves operate in an uncertain environment. This discussion highlights that the concept of knowledge creation, is a more useful than simply information asymmetry to understand the lending relationship. Interviews confirm that the lending relationship involves a strong element of judgment on part of the bank

¹⁹⁰ Using mean exchange rate in mid 2005 of KShs. 72.93 to the \$, this is equivalent to approximately \$274,200 for FOB and GOB, \$137,100 for LPOB and \$68,500 for SPOB.

about projections of economic and sectoral growth, as well as the validity of individual borrowers' projections.

6.3.2 Impact of Poor Legal System and Unreliability of Collateral

The main reason for high non-performing loans that has been discussed widely in the mainstream literature is the poor legal system in SSA with insufficient enforcement of contracts and the inability of banks to recover against their collateral in case of default by the borrower (Daumont et al., 2004).¹⁹¹ The interviews confirmed that banks across *all* segments viewed this as a significant problem:

“This is a really serious problem. In particular when judgements are given against us on really flimsy grounds. For example, you must have read in the newspaper that in the ruling of XXX we lost the case as the debenture document did not state the name of the lawyer who had prepared it on the top page as is convention” - Interview Bank 1, FOB

“Legal problems are rampant even when disbursing the loan. Last year the government introduced new rules about land transfer. Now a land surveyor appointed by the Government has to go to property to confirm that the correct stamp duty is being paid. This has slowed down the process of putting a charge on a property dramatically. It takes over 6 months to get a security registered. Companies' registry is also disorganised. There is also a lot of fraud. For example we recently perfected the security for a staff loan and yet later found out that the land belonged to someone else” – Interview Bank 2 - GOB¹⁹²

“However, even if the judgement has come in our favour, the client often appeals and wins in the appeal. On average cases take 4-5 years. However in some cases we have had cases going on for 7 years without resolution”
Interview Bank 5 - LPOB

¹⁹¹ Also refer to the discussion in Chapter 2 on the law and finance school, which emphasizes the importance of protection of property rights for financial development.

¹⁹² ‘Perfecting a security’ means the process of completing all legal documentation involved in the pledging of collateral by a borrower to the bank.

In line with existing literature, this study found that banks complained about administrative delays in the courts, problems at both the lands and companies' registries, and corruption.

It has been argued in the mainstream literature that:

“Strengthening the legal framework will be crucial to improving the lending environment and reducing interest rate spreads. Legal reforms should include (i) reform of the Companies Registry to simplify registry procedures and allow for speedy and accurate information sharing of corporate information and data, (ii) reform and consolidation of the land registration framework to allow speedier searches as well as establishing more efficient mechanisms for registering and enforcing security interests over land and other real estate, (iii) strengthening and simplifying debt collection processes, including the introduction of procedures such as small claims procedures, summary procedures for uncontested debt, and alternative dispute resolution procedures, and (iv) institutional reform and training of judges. The combined effect of these measures would be to reduce credit risk for banks”

Beck & Fuchs (2004)

The crucial point to note here is that the issue of land in Kenya is extremely emotive and complex; highly intertwined in the process of capital accumulation and used by the state as a tool of political patronage (Johnson, 2003; Kanyinga, 2000a; Klopp, 2000). Therefore there are social, cultural and political reasons why foreclosure by banks is difficult (Shipton, 1992). “So touchy is the question of land auctions, that on more than one instance, they have been discontinued nationwide” (Shipton, 1992). While this point has been well recognized in the literature on micro-finance and rural agricultural land, it has been less recognized in relation to the formal banking sector.¹⁹³ However, as we now discuss, the social and emotional aspects of the land issue affects the formal

¹⁹³ For example, the World Bank's “Doing Business Surveys” simply reduce the problem to one of ‘number of days taken to register a property’ and ‘number of procedures’ necessary to register a property’. See <http://www.doingbusiness.org/EconomyRankings/> and therefore ignores the social and emotional aspects of the land issue.

banking sector as well. In particular it is difficult for banks to sell land that has been pledged as collateral, in case of default by the borrower.

In 1991, there was a Presidential Standing Order that prevented financial institutions from auctioning land first having this cleared with the provincial administration (Shipton, 1992). Similarly in 2003, the new NARC government introduced new processes on land transfers.¹⁹⁴ The two specific processes affected banks significantly - first, the need to get a government valuer to verify the actual value of the land and assess the stamp duty and second block on transferring undeveloped plots of land. Both processes had laudable aims. The block on transfer of undeveloped land was a measure to reduce speculative acquisition of land and also quick transfer of public land that had been allocated illegally. However, in many cases undeveloped plots of land had already been pledged by borrowers as collateral for loans. The verification by a government valuer was aimed at ensuring that the government received stamp duty at a fair price. Before that, the properties were often sold at an official price that is below the actual price paid to reduce stamp duty payable to the government. However, the banks complained that the government valuers often inflated the price and would only reduce it after they had received a bribe. There was no formal appeal process to object to the valuation of the government valuer. These two processes have significantly increased the time for registration of properties. Furthermore, it has made it impossible for banks to recover against their collateral in case of default by the borrower in the cases where the collateral is an undeveloped plot of land.¹⁹⁵

In December 2004, the Government of Kenya released the findings of Commission of Inquiry into the Illegal / Irregular Allocation of Public Land (Ndungu Land Commission Report, 2004).¹⁹⁶ It catalogues in extensive detail the illegal land awards made to the families of previous Presidents Kenyatta and Moi and other politically connected individuals. It highlights how the extensive illegal appropriation of public land was central to the formation and consolidation of Kenya's political elite often on

¹⁹⁴ NARC stands for National Rainbow Coalition - which was a coalition of parties that won the election in December 2002.

¹⁹⁵ Conversations with a prominent lawyer revealed that some banks had resorted to building a wall around the plot to indicate it was 'under development' before being able to sell it to recover on a non-performing loan.

¹⁹⁶ This report has become popularly known as the "Ndungu Commission Report" after the Chairman of the Commission, lawyer Paul Ndungu.

tribal grounds (Ndungu, 2006; Southall, 2005). The Commission made several recommendations including the computerisation of land records, the setting up of a tribunal to review the illegal allocation of title deeds and if necessary the revocation of title deeds and the establishment of just land policy (Ndungu, 2006; Southall, 2005). All these actions are extremely difficult in light of the fragile political situation in Kenya, following the post election violence in early 2008. A recent report by a Kenyan think tank recognized that by mid 2008, very little action had been taken by the government on implementing the recommendations of Ndungu Report (African Centre for Open Governance (AFRICOG), 2008). Banks interviewed during this research reported that they had begun checking the Ndungu Report, and properties mentioned adversely in the report was no longer considered as suitable for use as collateral.

The Commission also gives a historical perspective on the development of land law in Kenya that is worth reflecting on here. The land system in Kenya that developed under colonialism was based upon the Crown Lands Ordinance of 1915 and in this the authority to allocate Crown lands was vested in the Monarch while direct power of allocation given to the Commissioner of Lands (Ndungu Land Commission Report, 2004). At Independence, these colonial laws were adopted with only superficial amendments which meant that the powers vested in the British Monarch were transferred to the President of Independent Kenya (Ndungu, 2006). The aim of direct grant from the commissioner was to restrict access by African populations to the “White Highlands”. Therefore the system fulfilled the goals of the colonial administration, but had extremely detrimental effects on land allocation in independent Kenya:

“[one of the] greatest ironies in the history of land allocation in Kenya, what appears to have succeeded in the colonial period (i.e. allocation by direct grant) is what later facilitated the massive illegal and irregular abandonment of public land by the Government after independence, for it was to be the very officials and institutions charged with being the custodians of public land who were to become the facilitators of illegal allocations”

Ndungu Land Commission Report (2004 pp., 6-7)

In line with mainstream literature therefore, this study found that poor legal systems affect *all* segments of the banking sector. However, the problem is much more complex than simply an issue of unstable property rights, or English vs. French origin legal

systems as characterised by the mainstream literature in particular the law and finance school.¹⁹⁷ Kenya is one of the few African countries that at independence enacted individual title for tracts of indigenous land and also redistribution of parts of the 'White Highlands' (Southall, 2005), and yet significant problems remain.

The Ndungu Report highlights the complexity and non-linear nature of institutional development and inter-linkages with the process of capital accumulation. Therefore, the policy suggestions of Beck and Fuchs stated above, which if put in place would undoubtedly lower the levels of non-performing loans, are contingent on the broader institutional development of the country.

Furthermore, the unreliability of collateral means that social factors are extremely important in developing trust between banks and borrowers as will be described below. All banks interviewed stated that they only did unsecured lending to the very top clients. However even collateral based lending involves a reliance on social ties between bank and borrower for the bank to make a judgement on the likelihood of default and the reliability of collateral.

As discussed in Chapter 3, the literature on lending and non-performing loans in SSA focuses on macroeconomic problems, poor legal systems and poor regulation of banks across African countries and then moves into S-C-P analysis for single country studies.¹⁹⁸ There is no empirical analysis on the reality of lending practices in the banking sector.

6.4 Constraints to Lending – Fluid Social Factors and Inadequacies in Information Production and Monitoring

The remainder of this chapter shows that the different segments of the banking sector face different constraints, in terms of the lending process and information collection. Many of these constraints are based on social factors and these explain the differences in non-performing loans between the segments. It should be noted that all banks in all

¹⁹⁷ Refer to Chapter 2 for criticisms of the law and finance school.

¹⁹⁸ S-C-P stands for the structure-conduct-performance analysis discussed in Chapter 3. In summary, these studies argue that the poor performance of the banking system in Kenya can be attributed to low competition as a result of the high concentrated banking structure.

segments develop long-term relationships with their clients. In terms of length of relationship, there is no significant difference across segments, with all banks stating that they had long-term (more than five years) relationships with their clients. Therefore this cannot explain the differences in performance of loans between the segments.

6.4.1 Information Production by FOB – The Benchmark

The section begins by looking at the information production process used by FOBs. As shown in Chapter 4, FOBs have the lowest NPLs and are therefore used as the benchmark for information production.¹⁹⁹ Furthermore, apart from FOBs, banks in all other segments expressed that credit manuals and procedures were inadequate ‘in the past’ and that the weak and in many cases undefined processes was a key reason for the high levels of non-performing loans. The FOB interviewed shared a copy of their credit appraisal of a client.²⁰⁰ The information contained in the credit appraisal is summarized in Table 23.

Table 23: Information Collected by FOB - Benchmark

Hard Information	Soft Information
Name of Client	
Total financing limit	
Introduction to the client	
General Economic Conditions	
Review of the Industry – Growth and Threats	
Market position	Strategy (the target market of the client, expansion plans, new products, investment plans)

¹⁹⁹ Interviews also revealed that banks in other segments viewed the FOBs as having the best practice procedures in terms of information. While the information production practices of FOB are used as a benchmark, as emphasized in Chapter 4, we recognize that the experience of the Kenyan banking sector shows that the simple *presence* of foreign owned banks will not lead to improved credit allocation outcomes by other segments of the market.

²⁰⁰ From the interviews the credit appraisal of this FOB can be viewed as representative of practice in the FOB segment.

Hard Information	Soft Information
Operating and Financial Performance (each of these was given a score in a model). Analysis of asset size, Capitalization, Liquidity, Cash flow analysis, Asset Quality including quality of debtors and creditors using age wise analysis, Types and diversity of Income, Review of Management Accounts	Understanding any 'tax management' of financial accounts.
Names of Shareholders	Ultimate beneficiary of the shareholding (because shareholding is often held in company name)
Directors of the client and their qualifications	Other directorships of the directors and whether they are 'well regarded' in the local business community
Company Registration	Check at companies registry to confirm registration of company
Management structure	Previous experience of the management structure
Auditors	Reliability of the auditors
Facilities with Other Banks	Reference from other bank
Collateral (Security)	Check with land registry on collateral

The main aim of the Table 23 is to show that even FOB, which have the most arm's length relationships with their clients, rely heavily on soft information during the credit appraisal.²⁰¹ In particular the reputation of borrowers or reputation of auditors can only be understood by the bank through embedded social networks. Furthermore, in a developing country where the company registry and land registry are not functioning well, checking the ultimate shareholder of a company or the validity of a title also requires, is not merely a mechanical process but a process that requires social knowledge. This table emphasizes the argument of Uzzi discussed in Chapter 5 that hard information and soft information are complementary. Furthermore, arm's length ties

²⁰¹ To reiterate the distinction between hard information and soft information that was discussed in Chapter 4 - Hard information consists of firm or project specific financial data from borrowers' balance sheets and also industrial data. It is already in numerical form therefore easy to quantify, verify and transfer. Soft information is qualitative and based on 'words' including ideas, opinions and comments. Therefore by its nature it is difficult to quantify and is generated in the specific context of the bank-borrower relationship and its use relies on some level of judgment.

and embedded ties are also complementary. This is in contrast to mainstream literature that emphasizes the superiority of hard information over soft information.

Once credit analysis is done, the FOB had set approval levels given to each credit officer. The very largest loans had to be approved by the Regional Head Office jointly with the Board Credit Committee. The FOB also had in place monitoring guidelines including early warning triggers for NPLs.

The process outlined above might seem a fairly ‘standard’ credit appraisal process by international banking standards. However banks in other segments (particularly LPOBs and SPOBs) are unable to follow this benchmark credit appraisal process due to several constraints, which are mainly social in nature, which we now discuss in detail.

6.4.2 Lack of Credit Registry and References from Other Banks

Theoretically, it has been argued that information sharing between banks will reduce the problems of asymmetric information and poor enforcement leading to higher lending and lower interest rates (Jappelli & Pagano, 1993). The interviews revealed that information sharing between banks in Kenya was very weak and banks from all segments found this a constraint. The banks complained that references from other banks were either unreliable or too vague to make any meaningful decision. The managers of FOB and GOB said that they were often able to get information through a ‘silent network’ of staff in other banks that had worked for the FOB or GOB before. However, all LPOB and SPOB found this a big constraint.

“This is a major problem. Banks are self-centred and don’t want to share information. NPLs are a big problem and banks don’t want to go through process of selling a security etc. So they won’t mind if they can get another bank to send them a cheque. The official bank opinion hardly says anything substantial and comes with a big disclaimer. Banks hardly share information on an informal basis.” – Interview, Bank 3, LPOB

The establishment of credit reference bureaus is a key policy tool pursued by the World Bank and the IMF to enforce the sharing of information and therefore improve the ability of banks to appraise credit (Honohan & Beck, 2007). This is based on cross-country studies which show that access to credit is improved in markets where credit

registries are present (Jappelli & Pagano, 2002; Love & Mylenko, 2003). In Kenya, legislation for the establishment of credit reference bureau was part of the World Bank FSAP recommendations (Central Bank of Kenya, 2006a; Lumiti, 2008). The legislation was tabled in parliament in 2006 and passed as a bill 2008. In 2009 the first company - CRB-Africa - was licensed to operate a credit reference bureau and it began operations in July 2010. As the credit reference bureau came into effect after the period of the data and interviews in this thesis it is very difficult to judge empirically the impact of the bureaus on access to credit. One unique study on retail lending discussing the impact of the introduction of credit registries in China finds that the registry did *not reduce* credit rationing on average but changed the way the bank used information. Borrowers who had both positive internal information (held with the bank) and positive external information (held with the credit registry) received higher credit card lines (Cheng & Degryse, 2010).²⁰²

The interviews indicated that a credit reference bureau would be mainly helpful for retail and individual lending and less helpful for corporate lending. Banks in Kenya through the Kenya Bankers Association had also been lobbying the government to establish the legal framework to establish credit registries. Therefore, the author found this more nuanced view on credit registries very interesting. We have not seen any studies that attempt to understand the differential impact of credit registries on retail lending vs. corporate lending. However, we can conjecture that the reasons for the cautionary response to credit registries in the interviews are two fold. First, according the Kenyan Banking (Credit Reference Bureau) Act 2008, it is *mandatory* for banks to share negative information, for example default by a borrower, but *optional* for banks to share positive information. However, positive information for example on projected growth rates is essential for a successful corporate lending. Secondly, as said above, corporate lending requires a high level of ‘soft information’ that is extremely difficult to capture in numerical data in a form that is easy to transfer. This also enforces the theoretical concept discussed in Chapter 5 that hard information and soft information are complementary and that arm’s length ties and embedded ties are also complementary.

²⁰² Emphasis added.

6.4.3 Over-reliance on Security Based (Collateral) Lending

LPOBs and SPOBs recognized that in ‘the past’ there had been excessive reliance on security based (collateral) lending. Therefore a valuation of the collateral was carried out and then a loan based on a certain percentage - for example 60% to 80% - of the value of the collateral was given. There was not sufficient attention given to the expected cash flow from lending and the ability of the project to generate repayments and this contributed to the high level of NPLs. Refer to Table 22, Line 4.

“Generally security is very important and in the past we relied on it a lot.”

Interview Bank 6, SPOB

“We also do cash flow analysis which we did not do in past.” Interview –

Bank 7, SPOB

Bank 6, SPOB shared two different credit appraisals with the author – an old credit appraisal which was used up to 2004 and a new credit appraisal which was used from 2004 (refer to Appendix 18 and Appendix 19). Both credit appraisals refer to the same company but reveal stark differences. The old one carried out a simple ratio analysis and a list of the securities used for collateral. The new credit appraisal undertakes an explicit analysis of several risk factors including business risk, financial risk, management risk (including an analysis of ownership), structural risk (including an analysis of the business plan), security risk and account performance risk. Other key changes included asking clients for management accounts and not just audited accounts and being more diligent about visiting clients’ premises.

6.4.4 Overreliance on ‘Name Lending’ and Change in Social Factors

Table 22 also lists the ethnicity of the ownership of banks interviewed.²⁰³ There was recognition amongst LPOB and SPOB where the ownership was Asian-African, that ‘in the past’ there was an over-reliance on social factors or ‘name lending’ during the credit allocation process. Name lending refers to the process whereby the owners of the bank know the ‘name’ of the borrower as they were from the same community, and a loan is given purely on the perceived reputation of the borrower. This perceived reputation is

²⁰³ Refer to Chapter 4 for a detailed analysis of the ownership of banks in terms of ethnicity.

based purely on social factors. This was not seen a constraint amongst FOB, GOB or in LPOB where ownership was mixed.²⁰⁴ (Refer to Lines 5 and 6). There was an explicit recognition that community links that were used to get information on and monitor borrowers in the past had broken down over time and could no longer be relied on. In general bank managers referred to communities becoming less tightly knit and therefore they were either unable to get information on borrowers or monitor borrowers using social networks:

“There was also a generational change both among the bank owners and the borrowers. With new wealth people became less conservative and more aggressive.” Bank 5, LPOB

“The way of lending has also changed. Name lending was possible in the past. In the past you could also do name lending very successfully. The market was very small; communities were very tightly knit; and whatever there was to know about a person you knew it. People valued their reputation above all else. Now due to expansion you cannot know everyone and also more than personal reputation, it is the company reputation that is important. The honesty of the olden days is not there. As late as 2003 we did some name lending to a very old customer who had been with our bank for many years. They borrowed 30 million and then absconded to the UK. It is hard to do lending based on trust now.” Interview - Bank 7, SPOB

“We at that time had not stringent procedures. Certain groups were given loans out of trust. But some people abused this trust. We were sometime wrong in our evaluation of the family as the second generation was not as trustworthy as the first generation that we knew well. ” Interview - Bank 6, SPOB

The reliance by Asian-African SPOB interviewed on clients from within the Asian-African community also had a negative impact on non-performing loans when four Asian-African banks closed in 1998.²⁰⁵ Members of the Asian-African community lost

²⁰⁴ That is both African and Asian-African.

²⁰⁵ These were Trust Bank, Reliance Bank, Bullion Bank and City Finance Bank.

their deposits in the closed banks and this had a knock on effect in terms of their ability of repay loans taken in other Asian-African banks.

“There was also the impact of the closure of banks on several Asian-African families. Many Asian-African families lost their entire savings in Trust Bank.” Interview – Bank 5, LPOB

The implication of this for economic theory is complex. It shows that credit relations are embedded in social relations and that the information asymmetry between borrower and lender cannot be captured solely through transaction costs. However, it also shows that within one system, social relations have differential impacts. As discussed above, this constraint was not a problem for FOB or GOB. Furthermore, with specific reference to the SPOB segment it shows that social relations change over time and in this specific case, the change in social relations had a negative impact on the asset quality of loans held by banks. It is useful to recall the discussion in Chapter 5 on embeddedness of social relations and the emphasis by Granovetter that when systems are based on trust created by social relations, distrust and opportunism are not absent.

Though this thesis does not attempt to understand why these social relations changed for the SPOB segment, it points to the need for inter-disciplinary research.²⁰⁶ From the discussion above, it can be seen that relationship between Asian-African banks and their predominantly Asian-African clients reached a situation where informal social monitoring mechanisms broke down without formal monitoring mechanisms developing adequately to replace them. Anthropological and sociological research would be necessary to understand the reasons why social relations broke down. For example, theoretical concepts developed in sociology such as Giddens’ concept of modern risk societies would be useful to incorporate in future research. Modern risk societies necessitates increased level of trust in institutions away from personal trust; but are societies where traditional norms that allowed trust at personal levels are no longer relevant but have not been replaced with fully modern norms (Giddens, 1991). It would also be useful to carry out research similar to empirical studies from economic history.

²⁰⁶ Due to the hegemony of mainstream neo-classical economics, inter-disciplinary research has declined considerably in economics (Fullbrook, 2004). Also refer to discussions on the hegemony of mainstream economic methods in SSA research in Chapter 3.

For example as Grief(1993) which describes the existence of ‘multilateral punishment systems’ in 11th century Maghreb trade (Greif, 1993).²⁰⁷

6.4.5 Unreliability of Financial Accounts (‘Hard’ Information)

A key constraint faced by LPOBs and SPOBs was the reliability and accuracy of their clients’ financial accounts as these are usually ‘tax managed’ as depicted in Table 22, Line 3. ‘Tax managed’ is a euphemism for double accounting standards – where two sets of books are kept – one for reflecting the true position of the company and another, which is audited and used for tax purposes. The banks will only have access to the audited accounts and not the parallel set of true accounts. They generally use rules of thumb to assess to adjust to the accounts to get a ‘true’ picture. These adjustments are based on their knowledge of the client. While it is generally assumed that true position of the company is more profitable than the audited accounts, this assumption may not be true and makes credit assessment extremely difficult.

“All financial statements are tax managed so it is very difficult to get an accurate picture.” Interview – Bank 5, LPOB

“Audited accounts are next to worthless but help to identify trends.” Interview – Bank 6, SPOB

“50% of the times we are not comfortable. Most clients have 2 sets of books. They are very honest with us and say that they do not like paying taxes when the government is not delivering.” Interview – Bank 7, SPOB

Due to the size of the clients of LPOB and SPOB, and the fact that the majority of these clients are family owned businesses, the problem of inaccurate financial statements is more acute. It should be noted that as ‘tax management’ will involve a large part of

²⁰⁷ Grief studies 11th-century Maghreb traders and the institutions used by them to employ overseas agents despite the information problems inherent in these relations. He shows that this system stable due to the existence of a ‘multilateral punishment system’ where failure to honour a contract with one member of a community is punished multilaterally due to loss of reputation and future restriction of business links with all other members of the community. It is possible only in very small tightly knit communities and furthermore this punishment system is seen as more effective than a purely bilateral punishment system in terms of reducing agency costs (Greif, 1993).

the company's business being carried out in cash terms it is usually only possible in smaller, owner-managed companies. As said above the majority of clients of FOB and GOB are large corporations and the interviews stated that they did not consider this a problem.

“Most of our clients are at top end of the market so generally we get good financial statements.” Interview – Bank 2, GOB

Therefore even as banks in LPOB and SPOB segments make changes to their credit appraisal processes, the size and ownership pattern of their clients and in particular the fact that their audited accounts do not reflect the true picture, makes it difficult to rely purely on hard information to make credit decisions.

However, banks in all segments supplemented the analysis of hard financial information from financial statements with other soft information to get a better understanding of financial statements and also improve their reliability. As said in Chapter 5, by its nature, soft information can only be accessed through embedded relationships or social networks. The most important soft information criterion was an explicit review of the *reputation* of the auditor. Bankers spoke of an unwritten list that set out in hierarchical terms the perceived reputation of the auditors. Again, it has to be recognized that this list is made purely on the judgment of bankers based on their personal and social networks with auditors. In Appendix 19 which is the new credit analysis template for SPOB, attachment no 3 entitled financial risk, has an explicit discussion on the name of the auditor and reputation of the auditor. Other soft information criteria included reviewing the conduct of the bank account, supplier checks, debtor checks and reputation of the borrower. This shows that soft information is still extremely important when making a credit decision and that hard and soft information are complementary. This is line with the work of Uzzi discussed in Chapter 5.

Therefore, amongst Bank 6, SPOB and Bank 7, SPOB there was a transition from the non-formal ‘name lending’ based on social factors to the explicit use of soft information based on social factors in the credit appraisal process.

6.4.6 Lapses in Internal Control

Across the segments, even amongst the FOB and LPOB that had good credit policies, lapses in internal controls were seen a source of non-performing loans:

“Yes we have had cases of negligence on part of the relationship manager when it comes to monitoring. The main problem is that relationship manager becomes too close to client and even when there is no direct fraud, RMs tend to downplay downward trends. And not pay attention to obvious dangers” Interview – Bank 3, LPOB

“Of 12 big bad loans..[in]..about 8 or 9 there was misjudgement on part of the managers or a *‘willing suspension of disbelief’*. Often it is *not* that the manager was *colluding* with the borrower but just that they have had such a long relationship that the manager just does not see what is happening. We have done a review of the bad loans and the main reason is always the same - the manager did not want to cut the losses. Just not willing to accept the clients are lying as you have had a long relationship with them. They are scared of letting go of business.” Interview – Bank 4 - LPOB

Again however, the reason for these lapses is social in nature – the Relationship Manager (RM) becoming *too close* to the client and being *scared* to let go of business. However, these problems are compounded for SPOBs due to the large overlap between borrowers and depositors in the SPOB segment (as will be discussed below). In SPOB there is usually one relationship manager dealing with both the borrowing and lending side of the relationship:

“There is also the small bank mentality that we face. Small banks are averse to sending customers away. Because of the size of our bank we are often *intimidated* by our customers. Also because of strong relations it sometimes becomes tricky. It then becomes hard for the relationship manager to decline the demands of the client.” Interview – Bank 7, SPOB

6.4.7 Constrained by Image as Ethnic Bank

There was a strong recognition amongst LPOB and SPOB, where the ownership was Asian-African that they were restricted by their image as an ‘ethnic’ or ‘community’ bank and also restricted within their client base which was not growing. Refer to Table 22, Line 10:

“Our strategy has been to move out of our image as a community bank. We are now a professional bank and therefore our image has changed within the market. Our growth strategy could not have been met by the traditional ethnic base and therefore we had to change our strategy.” – Interview – Bank 5, LPOB

“The average middle class African will always go for a big brand and therefore the international banks have a big advantage. However we are automatically branded with other Asian banks. We are trying to change our profile but it is difficult to overcome. We are not walking away from our traditional Asian client but broadening our client base.” Interview – Bank 6, SPOB

Therefore, banks are not considering their traditional client base as their sole niche. However, in trying to diversify from it, banks are facing significant barriers in terms of perceived reputation based on their owners’ ethnicity. It should be noted that we are not arguing that the structural problems of the Kenyan banking system are because of poor race relations in Kenya. We are arguing that social factors are key in building trust between banks and borrowers, and due to the colonial and post independence history of Kenya, ethnicity is a key factor on which perceived reputation is based.

6.4.8 The Need to Educate Clients

One of the most interesting results from the interviews was the recognition by LPOB and SPOB for the need to educate their clients who were small and medium sized, overwhelmingly family-owned enterprises:

“Our customers also need to be educated. They think that when they come to us they will not have any problems. Of course that is true but we also

cannot tolerate everything. For example we have to *educate* them to call us before writing a cheque for which they don't have funds but expect us not to bounce it." – Interview, Bank 6, SPOB

SPOBs also indicated that they had to educate clients on the importance of preparing management accounts, as it was not common practice amongst their clients. Bank 5, LPOB and Bank 6, SPOB, also indicated that it worked with clients on succession planning issues surrounding family businesses and Bank 7, SPOB also indicated that they attempted to help resolve disputes between family members as these made family businesses particularly prone to failure. Again, this highlights that the concept of knowledge creation is more useful than information asymmetry to understand the complexity of the lending relationship as it recognizes that both borrowers and banks are coping with uncertainties. It also highlights that different segments of the banking sector face clients of significantly different size and type.

6.4.9 Regulation on Lending

As stated in Chapter 1, this thesis does not go into depth on the role of regulation on bank performance and fragility. However, it is useful to briefly discuss the changes that have taken place in regulation with specific reference to lending.²⁰⁸ It should be recognized that before 2000 there were very few prudential regulations in relation to lending and in particular provisioning for non-performing loans. For example, Trust Bank, which closed in 1998, had a non-performing portfolio of over 50%. It had a loan portfolio of approximately KShs. 10 billion and it was reported that 5.2 billion of this was non-performing (KPMG, 1999). However, the annual report of 1997 does not reflect this very weak position of the bank. The total provisioning in the annual report of 1997 is only KShs. 374 million (Trust Bank Ltd, 1997). This lack of regulations is part of the regulatory failure that has been recognized to contribute to the bank failures (Brownbridge et al., 2005).

In 2000, the CBK issued Prudential Guidelines. The specific guidelines on lending are called "risk classification of loans and advances and provisioning for bad and doubtful loans and advances" circular no CBK/RG/10 (Central Bank of Kenya, 2000b). These give specific guidelines and when a non-performing loan must be classified as watch,

²⁰⁸ In Chapter 4 we discussed regulation in relation to capital requirements.

sub-standard, doubtful and loss; provisions for different categories of loans; guidelines on valuation of securities; the necessity of a tripartite meeting between the CBK, the bank and auditors before audited accounts are finalised; and the regular submission by banks to CBK of forms on the status of non-performing loans and insider loans (Central Bank of Kenya, 2000b pp., 134-154). It further states that provisions have to be charged through the profit and loss statement and not the reserves. It also provides strict guidelines on valuation of securities (Central Bank of Kenya, 2000b pp., 134-154). The new guidelines in 2006, updated the 2000 guidelines to specify that risk assessment by banks should be undertaken for all assets and not just loans (Central Bank of Kenya, 2006b).

Therefore, while these regulations will be useful to ensure that banks provide for non-performing loans adequately and on time, the efficacy of the regulation depends on the ability of the CBK to supervise banks. The regulations do not resolve the constraints faced by banks highlighted above and do not necessarily improve the capacity of banks to make good lending decisions. Furthermore, regulations do not address the segmented nature of the market and the social factors that constrain banks in lending as discussed above. Therefore while stricter enforced regulation is necessary to prevent the accumulation of non-performing loans, it is not sufficient, as it cannot address many of the social factors that are the source of segmentation and fragility.

6.5 Deposit Mobilization

In Chapter 4 we showed that Brownbridge (1998b) briefly discusses the problems faced by privately owned local banks in mobilizing deposits due to adverse reputation. Besides this there is very little empirical work on the constraints faced by banks in raising deposits in a developing country context. For the remainder of the chapter we focus specifically on interview data on the constraints banks face in mobilizing deposits linking these to the theoretical concepts that we had developed in chapter 5.

As discussed in Chapter 4, the cost of funds for privately owned banks, in particular, SPOB are significantly higher than other segments.²⁰⁹ The aim of this short section is to understand the reason for this difference in cost of funds.

²⁰⁹ Refer to Chapter 4 - Table 21 and Appendix 15.

Privately owned banks, in particular, SPOBs face several economic problems when mobilizing deposits including the high cost of opening new branches and the high cost of introducing technology such as ATMs.²¹⁰ However, they also face several social and non-price hurdles when raising deposits.

As discussed in Chapter 5, perceived safety of deposits, and the trust of depositors in banks, is a key stage in financial development and it underpins the ability of a bank to extend loans (Dow et al., 2008; Lapavitsas, 2007).

The lack of trust of depositors in all banks was highlighted in a recent article in a Kenyan newspaper:

At a building along Nairobi's Tom Mboya Street, all that remains of the former Rural Urban Credit Finance is a dusty signboard that doesn't illuminate any more. More than 20 years after Kenya witnessed a wave of bank collapses; the safety of depositors' money has always haunted the industry — as customers ask: How safe is our money in the bank?

Irugu (2007)

The banking system in Kenya is at a stage where the central bank is unable to fully guarantee financial stability of all banks. The maximum amount insured by the Deposit Protection Board Fund (DPBF) is KShs. 100,000 and in 2005 the coverage was 16% of all deposits.²¹¹ Therefore there are different levels (radiuses) of trust within 'one' banking system. This means that social factors have an even stronger impact on the ability of banks to raise deposits. FOBs are viewed as strong and safe as they have the backing of their foreign partner. Similarly GOBs are viewed as safe as they are invariably bailed out by the government in case of insolvency due to high levels of non-performing loans. In fact the GOBs stated that they had no constraints in mobilizing deposits.

The interviews also reflected the change in social relations that was discussed in relation to lending above. In the past LPOB and SPOB relied on their community networks to raise deposits. Similarly, depositors felt comfortable with the owners of the banks as they often shared a long history of doing business with owners. This is reflected in the

²¹⁰ Refer to Chapter 4 for details on number of branches for different banks.

²¹¹ Author's calculation from Central Bank of Kenya (2005).

view of a SPOB founder who describes how the initial deposits for starting the bank were received from people who trusted him and his family:

“Initially it was easy to get money from people who trusted the family. These people have still maintained good deposits” (Bank 6, SPOB)

“Our main strength was our *family’s name*. Just by calling people we were able to raise deposits” (Bank 6, SPOB)

An article written in the national newspaper by an anonymous depositor of Reliance Bank after its failure also highlights how trust in the owners was key to securing depositors:

“Their family had a long and *trusted history* in the Asian business community. When the two original directors opened their finance house, Lake Credit Finance, they had a *good reputation* and won over many depositors. After some time United Bank was in problems and two of the directors managed to pull out of this institution, making sure that the depositors did not lose their funds. This earned the two directors *more respect* within the Asian community. Then Reliance Bank came into being. The core directors continued visiting the above mentioned towns and secured more funds from depositors.”

Anonymous Depositor (1999 pp., 9)

However over time the close community links have broken down and both depositors and banks have had to form new strategies. Asian-African LPOB and SPOB view their reputation as ‘ethnic banks’ as barriers to growth.²¹²

“It is our reputation as an ethnic bank which makes it difficult to raise funds from the wider public” (Bank 7, SPOB)

This perceived negative ethnic reputation is also reflected in articles in the Kenyan press:

²¹² This is also relevant for the discussion on lending as discussed above in Section 6.4.7.

“The managing partner of Ernst and Young, Mr. Waweru, said that there were multiple potential benefits to banks from merging...The small market in Kenya with banks providing traditional products with little innovation he said called for mergers. Further mergers could be used to dilute *negative* attributes like being identified with *a group of people*.”

Nzioka (1999 pp., 11)

It is also interesting to note that Asian-African banks are taking deliberate actions to reduce the effect of ethnicity on their reputation. Bank 5 LPOB, and Bank 6 and 7 both SPOB have recently hired British and African CEOs or Branch managers:

“Yes, we are known as an Asian bank therefore it is hard to get African clients. The recent move to appoint an African as an MD when the former Asian MD resigned was a *deliberate move to change the image of the bank*”
Interview – Bank 7, SPOB

“Our Karen branch which is in a non-Asian area is now our best performing branch. We hired relationship managers who knew the market in that area – particularly non-governmental organizations and churches – and offered products that matched the customer profile in that area” (Bank 5, LPOB).

Referring to the discussion in Chapter 5, by institutional economists, these strategies can be viewed as non-price attempts by banks to signal their safety to depositors.

It should be noted that LPOB that had a broader ownership base (Bank 3, LPOB and Bank 4, LPOB) did not express ethnicity as a constraint when mobilizing deposits. However, they did express that they were not perceived by the public to be as safe as FOBs. A senior staff member of Bank 4, a LPOB (both African and Asian-African ownership) commented that he still kept his personal account with a FOB even though the service was poor and interest rates very low, because he perceived them to be safe:

“As a staff of Bank 4 I also bank with a large foreign owned bank. I know *its crazy* but personally I still have an account with them as they are seen as trust worthy. They give bad customer service, they are expensive and *as a*

banker I know I am giving them free money and yet I do it. At least I can sleep soundly”- Interview, Bank 4 – LPOB

The interview also highlights that in terms of customer service the commonly held perception is that FOB and GOB provide comparatively poorer customer service than privately owned banks. LPOB and SPOB are perceived to provide more personalized and quicker service. However, their reputation for safety is much lower than FOB or GOB.

In Chapter 1 we had discussed the costs of bank failures. We would like to argue that a key cost of bank failures that has largely been ignored by the existing literature is the reputation effect on surviving local banks. Failures of local banks have a knock on negative effect on other local banks as depositors move to larger foreign-owned or government-owned banks assuming that local banks are generally unsafe. Local banks suffer a reputational bias even if they are sound, further deepening the segmentation between FOB and GOB and local banks. There is evidence for this in other SSA countries - for example after Zambia experienced bank failures in 1995, the proportion of deposits controlled by the five largest banks (which were government owned and international banks) increased from 65% in December 1994 to 80% in December 1995 (Maimbo, 2002). In Kenya, early accounts by a think tank indicated that the banking crisis of early 1980s led to a loss of confidence in locally owned private banks and a shift in deposits to longer established banks (Economist Intelligence Unit, 1986).

Our interviews revealed that the closure of four Asian-African and several small African banks in 1998 led to a flight to safety by depositors to FOB and GOB. The closure of these banks had negative impact on the *reputation* of all private banks, in particular, small private banks and their ability to raise deposits.²¹³

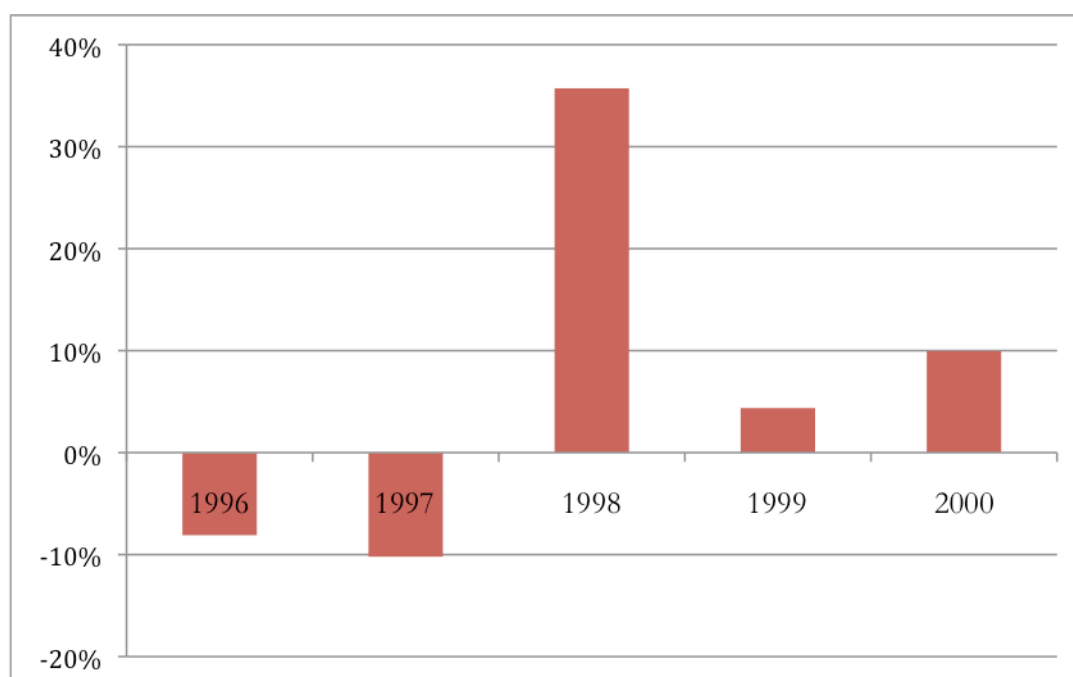
“Failures of other small banks means all banks are perceived as fragile”
Interview – Bank 6, SPOB

“Our main constraints are misinformation and *prejudice*” Interview – Bank 7,
SPOB

²¹³The negative impact of the failure of other private banks on the ability of private banks to get good borrowers was discussed above.

Interestingly Bank of Baroda and Bank of India, which are subsidiaries of banks owned by the Government of India, have been the main beneficiaries of this flight to safety from Asian-African banks. These banks traditionally served Asian-African clients before the rise of Asian-African private banks in the 1990s. These banks were perceived to provide very poor customer service compared to Asian-African LPOB and SPOB but after the closure of Asian-African banks they were perceived to be safer. Figure 10 shows that the growth rate of deposits of Bank of Baroda grew dramatically after 1997.

Figure 10: Growth of Deposits of Bank of Baroda



Source: Calculated by the author from financial statements of Bank of Baroda

These interviews highlight that SPOB feel constrained in raising deposits by preconceptions of their reputation. These preconceptions are not based on a neutral financial analysis of an individual bank's financial statements but based on a general view that depositors have of the segment in which the bank located. Asian-African SPOB banks interviewed felt that these preconceptions were unfounded as their capital ratios and liquidity ratios were well above the statutory norm.²¹⁴

²¹⁴ As discussed in Chapter 4, the capital and liquidity ratios of SPOB segment are above statutory norms.

In the mainstream literature it is argued that market discipline in particular monitoring by depositors is weak due to the opacity of financial statements.²¹⁵ In this regard the CBK has introduced a regulation that makes it mandatory for banks to publish their annual and quarterly accounts in the newspaper with the aim of increasing transparency and knowledge among depositors.²¹⁶ Analyzing the interview data, across the segments, FOB, GOB, LPOB, SPOB, there was consensus that quarterly publishing of financial data had not improved knowledge amongst depositors, shareholders or the general public.

“Even if people read them, they do not understand them. Really we have 40 banks so market discipline should work as customers can vote with their feet. But in reality even in western countries, there is very little attrition as it is difficult to move banks.” Bank 3, LPOB

“Only other banks look at these figures. General public don't look financial statements and even when they do, they don't really understand. People look international banks to seek for comfort. The depositors of smaller banks are mainly relying on the integrity of the owners.” Bank 6, SPOB

“Only other banks read the reports. How many people would even understand one bank's financial statement? How many would read 43?” Bank 9, SPOB

This point emphasizes the extreme complexity of regulating financial institutions. As discussed in Chapter 1 it has been shown that supervisory bodies in SSA are extremely weak due to a combination of poor capacity and tendency for capture (Alawode, 2003; Barth et al., 2006; Brownbridge & Kirkpatrick, 2002; Brownbridge et al., 2005; Kagira & Kirkpatrick, 2001; Lleewlyn, 2005). Yet, there is evidence that regulation by the market

²¹⁵ Market discipline is the 3rd pillar of the Basel II after minimum capital standards (pillar 1) and supervisory review process (pillar 2). Market discipline can be defined as “the influence that “outsiders” (that is stakeholders with no executive decision making power) exert on “insiders” (that is, the decision makers in the economic unit) that encourages value enhancing behaviour of the latter (Tsatsaronis, 2004).

²¹⁶ One of the instruments of market discipline is imposing more transparency, that is forcing bank managers to disclose more information so market participants can make better judgements on the bank's position (Rochet, 2004).

or market discipline has very little impact (Levy-Yeyati, Martinez Peria, & Schmukler, 2004; Llewellyn, 2004).²¹⁷

Finally, another important reason for the high cost of funds for privately owned banks is the large overlap between borrowers and depositors. The interviews revealed that one of the key differences between FOB, GOB and LPOB and SPOB is that the later have high overlap between borrowers and depositors. FOB and GOB stated that the overlap between depositors and borrowers is 2% and 5% respectively. LPOBs stated that the overlap was between 30-50% and for SPOB the overlap was 70-80%.

In general, FOB and GOB raise deposits from all their clients including very small depositors, mostly middle class salaried individuals. However the bulk of their lending is to large corporate clients of LPOB and SPOB depositors are high net-worth individuals acting in their personal capacity. Their borrowers are the small and medium sized companies in which the depositor (or high-net worth individual) is usually the chief executive or main shareholder. This has significant implication for competition in the segment. As said in Chapter 5, scholars of business management including Porter (1979) recognize that the bargaining power of customers has a strong impact on the nature and degree of competition in an industry. This concept is usually neglected when looking at competition in the banking sector where barriers to entry are simply viewed in terms of capital requirements or legislative restrictions on foreign ownership. The large overlap between borrowers and depositors in LPOB and SPOB segment means that their customers have much stronger bargaining power than customers of FOB and GOB. This is a strong institutional constraint is one of the key factors in understanding why FOB and GOB are able to enjoy much higher interest margins.

In the case of Asian-African SPOB the overlay between their traditional reliance on depositors from within their ethnic group (discussed above) combined with the reliance on a few large depositors has led to them feeling extremely restricted. For example at the end of 2005, Bank 7, SPOB had a deposit based of approximately KShs. 3.5bn. However they had 10 to 15 depositors who each had KShs. 30 million or more in the bank. That is, approximately 8 – 12 per cent of their deposits were held with only 10 to 15 depositors. Asian-African SPOBs interviewed complained of being ‘held to ransom’

²¹⁷ This point is also useful in the context of shareholder monitoring and market discipline that will be discussed in Chapter 8.

by their clients who would shift large deposits to other banks very quickly if the SPOB was unable to match the deposit rate requested by the depositor.

Interviews revealed the LPOB had taken distinct action to move above from this large overlap between depositors and borrowers.

“We have a fairly large overlap but it is reducing. In past we had a lot of back to back arrangements but now they form less than 15% of our lending” Bank 5, LPOB

Banks in the SPOB segment were just beginning to move away from relying a few large depositors to several smaller depositors. Asian-African SPOB had also experienced that whereas in the past they could rely on liquidating individual depositors if that depositors' company had defaulted on their borrowing, they could no longer do this. There were cases where the depositor had claimed in court that legally the company and his personal deposits were two separate entities.

The discussion above shows the ability of banks to compete depends on the bargaining power of customers, as highlighted in Chapter 5, but more importantly this bargaining power is markedly different for different segments of the banking sector. Therefore in the case of FOB and GOB, the bank is the price (interest rate) setter and the depositor is the price taker. For LPOB and SPOB, it is often the depositor that is the price setter.

The language used in the interviews in particular by SPOBs including terms like ‘prejudice’, ‘intimidated’ and ‘held to ransom’ are extremely emotive and highlight that non-price and social factors have a very strong impact on the ability of banks to raise deposits and also monitor borrowers.²¹⁸

It should be noted that small banks also pay punitive interest rates when borrowing from the CBK to cover gaps in daily transactions. It was reported in the press that a SPOB (which not named) had paid 6.75% interest to the CBK to cover a gap in daily

²¹⁸ Mainstream economists would be extremely uncomfortable with this analysis as it draws conclusions from subjective feelings of the subject being observed. However, this thesis follows the methodology of realists who argue that stereotypes and subjective feelings of what is appropriate, deserved or in this case not deserved, even though malleable, are social and real and therefore have powerful explanatory powers (Olsen, 2008). In this case, both banks and depositors act on conceived stereotypes.

transaction of KShs. 63 million when the interbank market rate was 1.73% (Irungu, 2010).

The discussion in this section also highlights the inter-linkages between fragility and segmentation in the banking sector. Fragility of a few banks leads to negative reputation of all banks in the segment, which leads to higher cost of funding, which in turn makes them more fragile. Therefore, segmentation is both the cause of and a result of fragility in the banking sector in Kenya.

6.6 Concluding Remarks

This chapter analyzes qualitative interview data on the lending practices of seven banks in Kenya and endeavors to understand the main constraints faced by banks in lending and deposit mobilization. As stated in the introduction we had shown in Chapter 4 that banks in SPOB segment face relatively high cost of funds, low spreads, high NPLs and low ROA. This chapter has shown the intricacies of information production and social factors that explain this differential performance.

The table below summarizes the previous chapters and compares the discussion in the current literature vs. the discussion in thesis in terms of theoretical concepts, reasons for high non-performing loans and reasons for high spreads. The table also summarizes the problems with the current literature.

	Current Literature	This Thesis
Theoretical Concepts – Lending	<ul style="list-style-type: none"> • Information Asymmetry • Structure-Conduct-Performance • Development Envelope Analysis 	<ul style="list-style-type: none"> • Knowledge creation – bank and borrower creating knowledge in an uncertain world • Embedded relationships and social factors help develop trust • Arm's length ties and embedded ties complimentary • Hard information and soft information complimentary • Social factors necessary to build trust but not sufficient to prevent breakdown in trust
Theoretical Concepts –	<ul style="list-style-type: none"> • Financial repression (low price) leads to low deposit mobilization 	<ul style="list-style-type: none"> • Stages of banking development - perceived safety of deposits is key stage in financial

	Current Literature	This Thesis
Deposit Mobilization		<p>development</p> <ul style="list-style-type: none"> • Trust in a bank's liabilities derives from the composition and quality of the assets • Difficult for depositors to judge quality of assets therefore rely on other signals from banks • Bargaining power of customers is important
Reasons for Non-performing loans	<ul style="list-style-type: none"> • Summed up as 'high transaction costs' • Conditions in the real economy but viewed as 'external shocks' • Poor legal systems viewed in simplistic way as stable property rights and English origin law vs. French origin law • Inadequate information production and monitoring by banks • Inefficiency due to highly concentration banking structure and lack of competition 	<ul style="list-style-type: none"> • NPLs are different for different segments of the economy. • Different segments have different client type and size. • Conditions in the real economy and borrowers risk particularly important as developing country – affects all segments • Poor legal systems affects all segments, but complex story when collateral, in particular, land is emotive issue • Lack of information sharing and lack of credit registry affects all segments • Constraints on information production and monitoring specifically for LPOB and SPOB <ul style="list-style-type: none"> ○ Over reliance on collateral lending ○ Over reliance on name lending ○ Unreliability of financial accounts ○ Lapses in internal control ○ Constrained by image as ethnic bank
Reasons for High Spreads	<ul style="list-style-type: none"> • Inefficiency due to high concentration and low competition 	<ul style="list-style-type: none"> • Spreads different for different segments • Spreads linked to deposit mobilization ability of banks and not only efficiency • High spreads for FOB and GOB not because of inefficiency but because they have lower cost of funds as they are trusted by depositors • Lower spreads for SPOB not because of efficiency but higher cost of funds because they are not trusted by all depositors

	Current Literature	This Thesis
Problems With Analysis	<ul style="list-style-type: none"> • Minimizes the role of borrowers' risk • Only explains credit rationing and not excessive credit • Hard information and arms' length relationships considered superior to soft information and embedded relationships • Very little empirical analysis of the reality of information production • Cannot explain differences within one banking system and segmentation • Barriers to entry viewed in very simplistic way in terms of minimum regulatory requirements • Very little focus on deposit mobilization 	<ul style="list-style-type: none"> • Difficulty in generalizing results for other banking systems

So what does this mean for finance and development as discussed in Chapters 1 and 2? The key measures proposed by the current literature to improve the performance of the financial sector are:

- Need to establish credit registries to encourage information sharing;
- Need to improve legal infrastructure and develop creditor friendly environments;
- Need to increase transparency to encourage market discipline; and
- Need to increase competition through reduction in barriers to entry (often interpreted as reduction in minimum capital requirements) and spill-over effects of foreign bank entry.

However, our discussion above shows that the story is much more complex. We have shown that:

- Heterodox theoretical concepts such as of knowledge creation, importance of social relations in building trust, and stages of banking development are more useful than pure information asymmetry.
- Within 'one' banking system there can be different radiuses of trust leading to segmentation of the system.

- Changing social factors have a pervasive effect on the quality of asset portfolio of banks and this impact is complex and not unidirectional.
- To be able to effectively monitor clients, banks need to develop a mix of arm's length and embedded relationships. Embedded relationships should not be discouraged by regulation.
- Credit registries are useful but do not replace the need for banks to really understand their clients.
- Hard information and soft information gathered by banks in the credit creation process are not substitutes but complementary.
- The importance of the complementarity of hard and soft information for banks' credit application process reinforces the relevance of our methodological approach in which we use both quantitative and qualitative data.
- Reputation is a key barrier for private banks to mobilize deposits.
- There is little evidence that increasing financial information about banks in the public domain leads to an increase in monitoring by depositors.
- Competition within segments is very high but it is very difficult for clients or banks to move between segments.
- Segmentation is the result of fragmentation rather than specialization.
- Segmentation implies that barriers to entry cannot be viewed simply in terms of concentration ratios but one needs to view the social barriers to entry.
- Segmentation also implies that there are few positive spill-over effects of competition.

The key point of this chapter is that segmentation is both a cause and consequence of the shallowness and fragility. In order to improve integration within the formal financial sector and reduce segmentation, there needs to be institutional arrangements for LPOB and SPOB to improve their reputation to allow them to compete with the FOB and GOB. Improvements in corporate governance are viewed as one way to improve the reputation of banks and this is the focus of the next two chapters.

CHAPTER 7 – THEORETICAL CONCEPTS ON CORPORATE GOVERNANCE RELATIONSHIPS

7.1 Introduction

In this chapter and in Chapter 8 we discuss the third important relationship in banking – the corporate governance relationship – that is the relationship between the bank and its shareholders.²¹⁹ As a starting point, it is assumed that better corporate governance, through better monitoring of management, will translate into better company performance (Bruno & Claessens, 2007).

In this chapter, we develop the theoretical background and discuss the debates in the corporate governance literature. In Section 7.2 we discuss general concepts and issues in corporate governance in particular the two models of corporate governance – the Anglo American and the Eurasian models. The debates on the links between ownership structure and corporate governance are discussed in Section 7.3. Specific board reforms and their impact on performance are discussed in Section 7.4. In Section 7.5 we engage with other studies on corporate governance in SSA. Corporate governance of banks with a special focus on the problems of insider lending are discussed in Section 7.6 and Section 7.7 provides concluding remarks.

The main aim of this chapter is to show that there is very little empirical consensus on what constitutes ‘best’ corporate governance practice. It is precisely because of this lack of consensus that studies in corporate governance are critical to understand the domestic factors shaping increasingly liberalized financial markets (Singh, 2005). This chapter forms the background to Chapter 8, where the ownership structures and board structures of the banking system in Kenya are analyzed and the impact of corporate governance regulation on actual practice is discussed.

²¹⁹ Refer to research questions in Chapter 1, Section 1.1.5.

7.2 Corporate Governance: Concepts and Issues

There has been increased interest in corporate governance after the Asian financial crisis of 1997 and the collapse of US energy giant Enron in 2002.²²⁰ Overall there has been a shift from looking at the macro-economic triggers for crisis to the microeconomic factors for crisis and the interest in corporate governance has been part of this shift (Glen & Singh, 2005).

Corporate governance remains difficult to define. A narrow definition of corporate governance is that it is the mechanism through which shareholders are assured that managers will act in their interests. This narrow view is based on the now seminal work on managerial agency reflecting the potential for conflict between owners and managers (Berle & Means, 1932; M. C. Jensen & Meckling, 1976). A broader definition is that corporate governance is the mechanism by which suppliers of finance control managers in order to ensure that their capital is not expropriated (Shleifer & Vishny, 1997). This view recognizes the debt and equity suppliers of finance have, differing order of claims on a firm in case of default and therefore differing appetites for risk and ultimately differing objectives for the firm. Furthermore, majority and minority shareholders may have different interests and therefore a wider definition of corporate governance should include mechanisms through which agency problems amongst shareholders are reduced (Bruno & Claessens, 2007). Therefore, this definition of corporate governance incorporates legal mechanisms for investor protection of small shareholders.

However, the high level of economy wide costs associated with large corporate failures has led to a vital debate - in whose interests firms should be run? (Becht, Jenkinson, & Mayer, 2005). It has been argued that there is a need for an even broader definition of corporate governance to include all stakeholders (Allen, 2005; John & Senbet, 1998).²²¹ This view, often referred to as 'the broadest' view, argues that corporate governance of

²²⁰ Before the Asian financial crisis of 1997 there were only a handful of studies on corporate governance. One of the most influential early studies was the Cadbury Committee Report on corporate governance in the UK which was published in 1992.

²²¹ The essential argument is that narrow definitions of corporate governance are based on the Arrow-Debreu models and fundamental theorems of welfare economics. As described in all major microeconomic textbooks, in a perfectly competitive economy, profit maximization by firms will lead to pareto optimum allocation of resources. However, in reality the strong assumptions of these models are rarely met even in developed markets. Therefore corporate governance should be concerned with mechanisms whereby firms are run to ensure that society's resources are used efficiently (Allen, 2005).

firms should be judged in terms of responsibility to society and not solely in the interests of the providers of finance (Allen, 2005). Following this broadest view, corporate governance can be defined as the design of institutions to ensure that the managements of companies act in interest of all stakeholders (Ayogu, 2001). In the case of banks, where bank managers also have a fiduciary duty to depositors, and particularly when there is full or partial depositor protection by the state, this broadest view of corporate governance is the most appropriate.²²²

Studies of comparative corporate governance have highlighted that there are two basic systems of corporate governance – the Anglo-American shareholder-oriented model and the Eurasian stakeholder-oriented model (La Porta et al., 1998). Table 24 shows the differences between these two models.

Table 24 : Comparison between Anglo-American and Eurasian Corporate Governance Models

Indicators	Anglo-American Corporate Governance Model	Eurasian Corporate Governance Model
Countries	USA, UK, Canada and Australia	Continental Europe, Japan and East Asia
Market Capitalization	High in relation of GDP	Low in relation to GDP
Sources of financing	Mainly, stock market – ‘Market based system’	Mainly, reinvestment of earnings and bank credits - ‘Bank based’
Character of Corporate Ownership	Diversified ownership	Concentrated ownership
Main shareowners	Individuals and institutional investors	Families, companies, the state, banks and other institutional investors
Structure of Board	One-tier structure consisting of board of directors	Two-tier structure consisting of supervisory board and executive board
Composition of the board	Board directors composed of executive and non-executive directors, at usual proportion of 1:3	Multi-interest supervisory board composed of representative shareholders, employees, banks, business partners, local

²²² Concepts for corporate governance of banks are just beginning to be discussed in the literature and they are discussed in more detail below.

Indicators	Anglo-American Corporate Governance Model	Eurasian Corporate Governance Model
		government
Committees by the board of directors	Presence of several committees such as nominating, compensation and audit committees	None
Other forms of control over the company	External control – exercised by the stock market (market for corporate control and hostile takeovers)	Internal Control – exercised by the company's stakeholders
Legal Protection of Minority Shareholder Rights	Strong	Weak
Disclosure requirements	Very Strict	Not very strict

Source: adapted from Dankova (2006)

This table is only schematic but highlights the link between different ownership structures and governance structures.²²³ Significant debates remain as to which type of ownership and control structures lead to improved management performance and it is to these debates that we now turn.²²⁴

7.3 Ownership Structure and Corporate Governance

Ownership structure is seen as a significant determinant of corporate governance and performance. The literature that focuses on the relationship between ownership and performance of firms is extensive in the context of the East Asian financial crisis. Literature particularly from the World Bank and the IMF has argued that the East Asian

²²³ There are significant differences within each of these models, and each of these models have also evolved over time. In fact, this bimodal classification has been rejected by authors who argue that it hampers a true understanding of governance mechanisms (Heugens & Otten, 2007). However, their attempt to have a more fine grained classification based on five corporate governance logics – include organization design, ownership concentration, dispersed ownership, managerial empowerment and esteem responsiveness - still draws on the corporate governance concepts captured in the table above.

²²⁴ The table also highlights the links between ownership structures and sources of financing – bank based vs. market based. It should be recalled from Chapter 2 that this debate is also unresolved in terms of which system is better for economic growth.

crisis arose from the *nature* of the ownership structure of East Asian businesses. The literature attempts to show that wide share ownership associated with the Anglo-American corporate governance model should be considered as 'best practice'. It is argued that highly concentrated ownership led to the development of 'crony capitalism' - where businesses are owned by a few large families with strong network of ties to between each other, politicians and bankers (Claessens, Djankov, & Lang, 2000).²²⁵ This 'crony capitalism' led to large scale systematic failure:

"The main lesson from the East Asian crisis is that it is important to take an integrated approach to the issue of corporate governance and financing. The poor system of corporate governance has contributed to the present financial crisis by shielding the banks, financial companies, and corporations from market discipline. Rather than ensuring internal oversight and allowing external monitoring, corporate governance has been characterized by ineffective boards of directors, weak internal control, unreliable financial reporting, lack of adequate disclosure, lax enforcement to ensure compliance and poor audits. These problems are evidenced by unreported losses and understated liabilities"

World Bank(1998, pp. 57)

The 'crony capitalism' school of thought bases its arguments on corporate governance datasets that have been developed. One dataset examines the separation of ownership and control for 2,980 corporations in nine East Asian countries. It is argued that concentration as a proportion of market value in the crisis affected countries of Indonesia, Korea and Thailand (61.7 per cent, 38.4 per cent, 53.3 per cent, respectively) is higher than in the non-crisis countries of Hong Kong, Japan, Singapore and Taiwan (34.4 per cent, 2.8 per cent, 29.9 per cent and 20.1 per cent, respectively) (Claessens et al., 2000). This high level of concentration of wealth is compared to the United States where in 1998 the top 15 families controlled only 2.9 per cent of GDP. Though even here, there remains a debate – another paper uses a different measure of concentration -

²²⁵ "The concentration of corporate control in the hands of a few families creates powerful incentives and abilities to 'lobby' government agencies and public officials for preferential treatment, whether through trade barriers, non-market-based financing, preferential public contracts or other means. Concentration of control might also have been a detriment to the evolution of the countries' legal systems. While we cannot document whether and through what channels crony capitalism has developed in East Asia, the large ownership concentration certainly raises the likelihood of it" (Claessens et al., 2000 pp., 109).

the cumulative ownership of the three largest shareholders among the top ten publicly traded firms world-wide and finds the ratio in USA as 20 per cent (La Porta et al., 1998) and concludes that, 'dispersed ownership in large public companies is simply a myth' (La Porta et al., 1998 pp., 1146).²²⁶

Glen and Singh (2005) raise several empirical weaknesses of this type of studies. With specific reference to the methodology of Claessens *et al.* (2000), they show that the robust association between concentration and crisis no longer holds when GDP rather than total listed corporation assets is used as the normalizing variable (Glen & Singh, 2005). Iskander & Chamlou (2000) have developed another data set based on the ownership structure of 20 largest firms by capitalization in 27 countries using 20 per cent threshold for control by and not just East Asia as done in the Claessens *et al.* (2000) paper. Appendix 20 summarizes the findings of Iskander & Chamlou (2000). Using these findings Glen & Singh (2005) persuasively show that ownership structure throughout the world is extremely diverse and the Anglo-American model of diffused ownership are quite uncommon outside the UK and US. There exist several examples of countries such as Sweden where ownership of assets is highly concentrated but there is no hint of cronyism in the economy (Glen & Singh, 2005).²²⁷

Furthermore, the 'crony capitalism' school of thought has been heavily criticized for its inability to reconcile the explanations for the rise and fall of East Asian economies. There is no clear explanation of why identical corporate governance practices were associated with both the rise and failure of East Asian economies (H.-J. Chang, Park, & Yoo, 1998; Glen & Singh, 2005; Singh & Weisse, 1999).²²⁸ Methodologically there is also a problem with the type of argument represented by the 'crony capitalism' school as 'crony capitalism' is assumed to be negative and by definition 'crony capitalism' is prevalent when there are high levels of concentration. Therefore this school assumes rather than proves that concentrated shareholding leads to cronyism and failure.

²²⁶ The terms diffused ownership, dispersed ownership and widely held ownership are used interchangeably.

²²⁷ In Sweden, the Wallenbergs, are believed to control 60 per cent of the country's industrial assets (Glen and Singh 2005).

²²⁸ As said above there are several contrasting views on the cause of the East Asian financial crisis but the main critics of the 'crony capitalism' school view the roots of the crisis in excessive and hasty and badly designed liberalization which led private sector firms to take on excessive debt (H.-J. Chang et al., 1998).

Therefore it can be argued that ‘crony capitalism’ arose from complex historical social and economic processes and is not necessarily linked to concentrated or dispersed ownership (Glen & Singh, 2005). It should be noted that the East Asian model of governance is similar in many respects to the European model of governance. The European model is also seen to arise out of the historical process of European social consciousness and tradition of co-operation between society, entrepreneurs and the state (Dankova, 2006). The ‘traditional’ Japanese corporate governance model has its roots in ‘corporate hegemony’ that evolved in Japan after the second World War, whereby management and labor each implicitly deferred their individual advantage for the benefit of the firm (Gordon, 1998). The Anglo-American model also arises from historical process and is underpinned by the notion, prevalent in the US in particular, that pursuit of individual interest will lead to optimum outcomes for society, and a general suspicion of the concentration of power (Dankova, 2006).

Country specific studies highlight the extremely complex nature of the relationship between ownership and the performance of a company. In a study of quoted companies in Thailand from 1996 – 2000, performance is measured in terms of debt/ equity ratio, return on assets and return on equity.²²⁹ The study shows that post crisis, family owned firms performed the best.²³⁰ This leads the author to argue that:

“..contrary to the traditional argument in favor of the model of good corporate governance, the group of corporations with no ultimate owners has always shown the worst business record among surveyed listed companies in Thailand.”

Suehiro (2001 pp., 12)

The lack of consensus on the impact of ownership on performance should not come as a surprise, as even theoretically it is very difficult to make a priori judgements as to which ownership structures lead to better resolution of agency problems between ownership and management, and therefore to better outcomes in terms of performance of the firm. This is shown in the Table 25 below which is drawn from Levine (2004). It

²²⁹ In the study, a debt/ equity ratio of 1 is seen as desirable (Suehiro, 2001).

²³⁰ The study uses five categories of firms - family owned firms, semi-family owned firms, Thai private widely owned firms, foreign owned firms and Thai state owned firms (Suehiro, 2001).

shows that each corporate governance mechanism to resolve agency problems has strengths and weaknesses.

Table 25 : Theoretical Links between Ownership Structure, Governance Mechanisms and Weaknesses in Mechanisms

Ownership Structure	Corporate Governance Mechanism	Weakness in Mechanism
Diffused Shareholding (many small shareholders).	Control through voting rights and election of board of directors. External control through threat of takeover.	Lack of expertise, high cost of monitoring directors and managers and ‘free-rider’ problems Weak legal codes protecting minority rights
Concentrated Shareholding (few large shareholders).	Have high incentives to collect information and monitor management and higher likelihood of electing directors who serve shareholders interests	Have incentive to maximize private benefit relative to minority shareholders

Source: Adapted from Levine (2004)

Therefore, while the resolution of the agency problem between owners and managers remains a critical factor in the performance of a company, it is difficult to specify, *a priori*, which ownership structures lead to improved performance.

It is also important to recall that the Anglo-American model of corporate governance emphasizes first, the role of the stock market and hostile takeovers as an external monitoring mechanism on management (Shleifer & Vishny, 1997) and second, the ‘law and finance school’ emphasis of the need for strong property rights and rule of law to protect minority shareholders (La Porta et al., 1998, 2000). Putting aside the significant arguments that are critical of both these arguments (Armour et al., 2008; Singh, 1992; Singh & Zammit, 2006), it has to be recognized that countries that attempt to establish codes of best practice based on the Anglo-American model of governance may not have a well developed market for corporate control or strong protection of minority shareholder rights.²³¹

²³¹ Refer to Chapter 2 for these debates.

7.4 Board Structure and Corporate Governance

The other major area of research in the corporate governance literature is concerned with board reform. The board is the key decision making body in a corporation and recently there have been an increased number of regulations related to the structure and conduct of boards and guidelines for directors (Becht et al., 2005). Board reforms can be categorized into three main areas: (i) reforms that constrain board discretion, by making boards more responsive to shareholder power and also giving gatekeepers such as external auditors more responsibility and influence; (ii) reforms to strengthen board independence including giving more responsibility to external directors; (iii) reforms that change directors' incentives that increase personal reputation and liability risk.²³²

It should be noted that the reforms are based on perceived best practice, yet there is little consensus on the link between board reform and firm value. We now consider some of this empirical work. This empirical work is largely related to the second category above, that is, reforms to give boards more independence from management. These studies can be grouped into four main aspects:- (i) reduction on board size, (ii) board independence and (iii) board committee structures and (iv) CEO duality.

7.4.1 Board Size

The large size of boards is seen as a limit on board effectiveness. The two main causes for this is that large size prevents meaningful dialogue amongst directors (Lipton & Lorsch, 1992) and large size boards are easier for the CEO to control (M. Jensen, 1993). Smaller boards are seen to provide stronger incentive for lower CEO compensation and stronger threat of CEO dismissal (Yermack, 1996). Some empirical studies have found evidence that smaller boards lead to better firm performance. For example, in a study of 452 US corporations between 1984 and 1991 it was found that the market valuation as measured by Tobin's Q had an inverse relationship with board size when the board size was between 4 – 10 members (Yermack, 1996).²³³ However, the study does not

²³² These reforms are meant to increase personal risk for the directors in case of company failure to ensure that they take their responsibilities as a director seriously.

²³³ A ratio devised by the economic analyst James Tobin of Yale University to measure the impact of intangible assets on business value. It is the ratio of the market value of a business to the replacement cost of its assets (Smullen & Hand, 2005). It is measured by year-end capitalization divided by the book value

explicitly show that the mechanism for poor performance of big boards is higher CEO compensation or lower threat of CEO dismissal.

A recent attempt at modeling the optimum board size uses a game theory framework (Raheja, 2005). The optimum board size is one that is most likely to reject 'a bad project' proposed by the CEO. This is a limiting assumption as in the real world, a CEO is unlikely to offer two starkly different choices to the board - good project or bad project, but rather to offer projects that may for example, be good in the short run but bad in the long run or not be fully cognisant of best strategy for the firm.²³⁴ Nonetheless, the model by Raheja (2005) is interesting as it recognizes that the optimum size of the board can vary with firm and industry specific characteristics.²³⁵

The lack of conclusive empirical or theoretical evidence from these studies point to the need for research to move away from empirical studies that simply attempt to link smaller board size with improved overall performance to studies that focus on how boards work and how they actually motivate and discipline CEOs.

7.4.2 Board Independence

It has been argued the 'outside' or 'non-executive' or 'independent' directors are more likely to act in shareholders' interests compared to 'inside' or executive directors as they do not have incentives to collude with internal managers to expropriate shareholders (Fama & Jensen, 1983; Monks & Nell, 2004). This argument is based on the view that outside directors often work as directors of several organizations therefore they would like to build their reputation as experts (Fama & Jensen, 1983). This view has proved extremely popular in American boardrooms and the ratio of inside directors has fallen from 38 per cent in 1973 to 25 per cent in 1993 (Monks & Nell, 2004).

of assets. And the sum of the market value of equity and the book value of debt divided by the book value of total assets.

²³⁴ Drawing on the arguments in Chapter 5 which emphasized that the information asymmetry between lender and borrower should not be understood in terms of the borrower having perfect information which is purposely hidden from the lender (Dow, 1998), it can be argued that it is false to assume that the CEO always has perfect information which he is trying to hide from the board.

²³⁵ In the model competitive industries and firms with highly concentrated ownership, require smaller boards as the incentives of management, CEO and executive directors are more closely aligned to shareholders (Raheja, 2005).

This view of outside directors as acting more closely in line with shareholders' interests has been questioned on several grounds. First, it is observed that non-executive directors rarely blow the whistle on mismanagement by executives (Morck, 2007). By using work in social psychology, it is argued that humans have an innate predisposition to obey authority and therefore do not always act in an optimal way even though they do not personally gain by supporting an errant CEO (Morck, 2007). Very often independence can also mean indifference and in general boards are more reactive than proactive (Monks & Nell, 2004). Secondly, while non-executive directors are independent of the CEO, it is the executive or inside directors that have more information and therefore their exclusion from the board can be detrimental to the performance of the company (Raheja, 2005). Therefore it is argued that in industries where it is easy for the shareholder to verify information such as grocery chain stores, a higher proportion for outside directors may be appropriate. However in industries where it is difficult to verify information such as in high tech firms, a higher number of inside directors may be optimal (Raheja, 2005).²³⁶ Thirdly it can also be questioned whether non-executive directors are truly independent as they many have hidden financial and personal ties to the CEO (Morck, 2007).

Empirical studies on the relationship between firm performance and the proportion of non-executive directors on the board also give mixed results. One of the main reasons for this is that it is very hard to separate the impact of executive directors and non-executive directors in firm performance. The studies discussed here are all based on US firms. There is some evidence that independent directors perform better in certain specific tasks such as replacing the CEO. It is found that in firms with a higher proportion of outside directors there is a strong correlation between poor performance and CEO turnover but that this correlation is not observed in firms with higher proportion of inside directors (Weisbach, 1988). Also the presence of outside directors is seen to be helpful during takeover bids. It is found in a study of 128 takeover bids from 1980-1987, that bidding firms stock returns are higher when there are at least 50 per cent independent directors on the board (Byrd & Hickman, 1992). However, even

²³⁶ This paper is very interesting as it highlights that different types of boards may be suitable for different industries. However, the model itself is based on very limiting assumptions such as the only reason why insider board members would reveal information to outside board members is to gain favour for future CEO positions.

studies that find positive relationships between independent directors and performance state that the relationship is not linear and there can be situations with ‘too many’ outside directors (Byrd & Hickman, 1992). The study by Yermack discussed in the previous section on board size finds a negative correlation between independent directors and firm performance when Tobin’s Q is used as a measure of performance, but no correlation when other measures of performance are used (Yermack, 1996). One study which focuses on the overall performance of 934 large firms from 1985-1995 finds no correlation between independence of boards and profitability (Bhagat & Black, 2002). They also find that while poorly performing boards often change strategy and adopt more independent directors, this strategy does not lead to improved profitability (Bhagat & Black, 2002).

Interestingly, reforms of corporate governance in Japan which have attempted to force companies to adopt outside directors have been rejected by some of the most profitable Japanese companies such as Canon (Buchanan & Deakin, 2007). As we will discuss in Chapter 8, reforms of corporate governance that do not take into account country specific ownership structures and practices may not achieve the intended consequences.

In summary, the evidence on the impact of outside directors on firm performance is very mixed and likely to depend on a variety of company, industry and country specific characteristics and also the skill levels and integrity of directors.

7.4.3 CEO / Chairman Duality

As discussed above the board is the device through which shareholders control management. The questions of whether the Chairman of the board and the CEO should be one person, or whether the role should be separated is another debate in the corporate governance literature. It has been argued that the role of the Chairman and CEO should be separate with the CEO having control of overall day-to-day management and the Chairman playing a non-executive role as head of the board. It is argued that giving these two powerful positions to one individual is detrimental to company performance due the domination of a single individual over the company and also a lack of separation of decision management and decision control (Fama & Jensen, 1983). Furthermore as a key function of the Chairman is to oversee the evaluation of and compensation for the CEO, if the position is vested in one person the CEO will

always act in his personal interest or will have excessive power over the committee that sets compensation (M. Jensen, 1993).

However, empirical studies on the actual value to the firm of separating the role of the CEO and Chairman are again mixed. The separation of the role of chairman and chief executive was one of the key recommendations of The Cadbury Committee Report which was published in the UK in 1992. Studies looking at the impact of compliance to the Cadbury report found that between 1988 and 1993 the number of quoted companies that had separation of the role of the Chairman and the CEO had increased from 58 per cent to 77 per cent (Dedman, 2002). The paper showed that separation of the CEO and Chairman role increased board oversight with respect to the manipulation of accounting numbers but there was no empirical evidence of an association between separation of the roles and overall firm value (Dedman, 2002). Furthermore, even companies that had a dual CEO/Chairman role, there was a failure to dismiss CEO's for poor performance particularly when CEO's were entrenched in the company with high levels of share ownership (Dedman, 2002). However, the study mentioned above on the US, showed a positive correlation between Chair/ CEO separation and firm value (Yermack, 1996).

7.4.4 Committee Structure of Boards

Codes of best practice of corporate governance stress the need for board committees as formal structures to ensure governance. Therefore boards are now required to have audit, nomination and compensation committees. It is recommended that these committees have at least one non-executive director to ensure independence. However, empirical studies on whether such a committee structure leads to improved performance are scarce. A recent study of 23 countries finds that existence and independence of board committees is positively and significantly associated with performance of firms (Bruno & Claessens, 2007). Though the same study highlights that the benefits of corporate governance measures are more valuable for large companies that rely on external finance (Bruno & Claessens, 2007).²³⁷ In summary, again it is difficult to specify *a priori* that committee structures will lead to improved performance of firms.

²³⁷ The study uses data on 5300 US companies and 2400 other companies from 22 advanced economies for the period 2003-2005. Performance is measured by Tobin's Q and return on assets. All the criticisms of large cross-country studies discussed in Chapter 2 also apply to this study.

In summary board reform has involved four main aspects - (i) reduction of board size, (ii) board independence and (iii) CEO / Chairman duality and (iv) board committee structures. This section has shown that theoretically the argument for reducing board size is mixed but the theoretical arguments for the other three reforms are fairly strong. However, empirically there is very little consensus on the impacts of each of these measures on firm value.

7.5 Corporate Governance in Africa

We now discuss studies that attempt to understand corporate governance practices in SSA. There are only a handful of studies of corporate governance in Africa. This section discusses in detail 4 papers – Ayogu (2001), Sanda et al. (2005), Kyereboah-Coleman (2007) and Sanda et al. (2007).

One of the earliest studies Ayogu (2001), is important as it recognizes the conceptual developments in governance theory. It discusses in detail the importance of change in focus from pure shareholder theory to stakeholder theory. In terms of empirical analysis, it focuses on 2 key measures – average board size and separation of the roles of CEO and chairperson. Table 26 summarizes the empirical analysis of Ayogu (2001).

Table 26 : Average Board Size and Separation of CEO / Chairperson Role in SSA

	Botswana	Ghana	Kenya	Mauritius	Nigeria	South Africa	Zambia
National Average Board Size	10	9	10	10	9	8	9
Modal Board Size	12	7	7	9	10	4	8
CEO as chairperson	NA	5 (23)	5 (54)	2 (43)	NA	NA	NA

Source: Ayogu (2001)

Notes:-

- 1) NA means not available
- 2) 5 (23) means that 5 of 23 firms combine the positions.

The analysis by Ayogu of data presented in Table 26 is then based on the study mentioned above - Yermack (1996) - which found an inverse correlation between board size and market valuation and that market valuation is higher for firms that separate the role of the CEO and chairperson.²³⁸ It is therefore argued that in terms of board size, “South Africa is the only country with a good record on this criterion” (Ayogu, 2001), as it has a modal board size of 4. This inference is highly problematic as the ‘ideal’ board size is based on a study of 452 large U.S. industrial corporations between 1984 and 1991 (Yermack, 1996) and therefore not comparable to African companies. There is no attempt to understand the link between board size and firm performance for the African countries that are being studied. In reference to data on separation of the position of CEO and chairperson the study recognizes that in Nigeria and South Africa, the position is combined in some of the largest corporations. In particular Anglo and Old Mutual - which formed 34 per cent of the valuation of all companies listed on the Johannesburg Stock Exchange in 1997 - combined the position of CEO and chairman. Therefore, the author presents evidence that shows that corporate governance practices in SSA diverge from the Anglo-American model but does not explain whether this divergence leads to positive or negative effects on firm performance.

The second study by Sanda *et al.* (2005) considers the impact of corporate governance mechanisms on performance of firms in the Nigerian Stock Exchange. The mechanisms of corporate governance considered by the paper are:- insiders’ or directors shareholding; the presence of outside directors; size of the board; ownership concentration; debt levels; separation of Chairperson and CEO and the presence of an expatriate CEO. Table 27 summarizes the main theoretical explanations, measurement used and conclusions of this paper. It is interesting to note that contrary to views of the Anglo-American model of governance, in this paper ownership concentration is assumed to be positively related to firm performance.

²³⁸ The paper quoted John & Senbet (1998) but that paper relies on findings from Yermack (1996).

Table 27 : Impact of Corporate Governance Measure on Firm Performance in Nigeria from 1996 - 1999

Variable	Theoretical Explanation	Measurement	Expected Relationship With Firm Performance	Relationship Found
Insider Shareholding	To motivate directors to act in shareholders' interest.	Total number of shares owned by directors of a given firm a percentage of the outstanding shares of the firm	Positive or U shaped	U shaped relationship
Outside directors	To monitor management	Proportion of outside directors on the board	Positive	Not significant
Size of board	Need to keep small	Number of directors on the board	Negative	Mixed results. Some equations show positive relationship and some show U shaped relationship (10 person ideal)
Ownership Concentration	To encourage monitoring by shareholders	The proportion of shares owned by the largest shareholders divided by the number of largest shareholders	Positive	U shaped
Leverage	To encourage monitoring by debt holders	Ratio of debt to share capital	Positive	Positive and significant
Separation of CEO and chairman	To encourage monitoring of CEO	Role of CEO if separate from chair	Positive if separate	Positive and significant
Expatriate CEO	Reason not explicit	A firm that has foreign CEO	Not stated	Positive and significant

Source: Sanda *et al.* (2005)

The study has several weaknesses. Firstly, the study uses pooled OLS regression with data from 1996 – 1999 rather than panel data analysis.²³⁹ Pooled OLS regression is generally used when one is trying to look for the impact of change between two periods (Wooldridge, 2006). Therefore, panel data estimators would have been more appropriate. Secondly, while the study uses 4 different ratios of firm performance – return on assets, return on equity, Tobin's Q and the price/equity ratio (Sanda et al., 2005), the results are generally only meaningful for the Tobin's Q measure.²⁴⁰ The authors argues that this is due to other measures being subject to 'accounting artefacts' (Sanda et al., 2005 pp., 30). This is not entirely convincing as Tobin's Q would also be subject the same accounting issues as it includes a measure of the total book value of assets and debt. It also raises the question of what is the best measure of firm performance when a company is not quoted and therefore Tobin's Q cannot be calculated. Furthermore, the study does not acknowledge that this is quite a common problem with econometric studies on firm performance including the one discussed above by Yermack (1996). Thirdly, data on ownership concentration is not available and a crude estimate was made by dividing the proportion of shareholding owned by the largest shareholders, divided by the number of the largest shareholders.

Notwithstanding these issues, the authors draw some interesting conclusions. The authors find the ideal board size in Nigeria to be 10 - which is relatively large compared to the studies on US firms.²⁴¹ This emphasizes the point made above that board size is dependent on industry and country specific factors. One of the surprising results for the authors is that independent directors do not have a significant impact on performance. The authors argue that this is because the outside directors are not independent enough. They suggest that there is therefore a "need for regulatory authorities to reassess the procedures for the appointment of outside directors in order to remove the influence of CEOs from the appointment process" (Sanda et al., 2005 pp., 30). However this may be an indication of lack of skills of outside directors. The study also finds that companies run by expatriate CEOs perform better than firms run by Nigerian CEOs. They attribute this to the tendency for foreign CEOs to have better skills than local

²³⁹ This weakness has been recognized by the authors though it is not clear why they have not addressed it.

²⁴⁰ See definition of Tobin's Q above.

²⁴¹ They find the optimal board size by including a term for square of board size and taking partial derivatives and solving for optimal values.

CEOs. This area would have greatly benefited from qualitative research that have shed light on the independence and skill level of outside directors.

The third paper, Sanda *et al.* (2007), is by the same authors, who carry out another study focusing solely on board independence and firm performance in Nigeria with updated data from 1996 to 2004.²⁴²

Table 28 summarizes the results of this study.

Table 28 : Impact of Board Independence on Firm Performance in Nigeria from 1996 – 2004

Variable	Measurement	Expected Relationship With Firm Performance	Relationship With Firm Performance Measured As RoA
Board Size	Number of directors	Control variable	
Board Size Squared	Variable created by the square of number of directors	Control Variable	
Firm Size	Asset Size	Control Variable	
Family Affiliation	Dummy created with value of 1 if owners or family members are directors of the board and 0 if otherwise	Negative	Not Significant
CEO Tenure	Dummy created which takes value of 1 if CEO tenure more than average and 0 if CEO tenure less than average in the sample	Postive – as poorly performing CEOs should be fired	Negative
CEO foreign	Dummy variable value 1 if CEO is foreign national and 0 if CEO is citizen	Positive	Positive and Significant

²⁴² The number of firms in 1996 – 1999 study was 139 while in the 1996 - 2004 study the sample was 204 firms.

Variable	Measurement	Expected Relationship With Firm Performance	Relationship With Firm Performance Measured As RoA
Ownership Concentration	Measured by proportion of shares held by controlling shareholders divided by number of shareholder. Dummy created with value of 1 if this ratio is above average and 0 if this ratio is below average	Negative, as interests of minority shareholders ignored	No relationship
CEO Audit membership Dummy	A dummy variable taking a value of 1 if CEO is member of audit committee and 0 otherwise	Negative - hinders independence of the board, information being passed on to the board	Negative
Outside Directors	Proportion of outside directors as a proportion of board size	Positive	Positive and significant

Source: Sanda *et al.* (2007)

Note:- For ease of presentation, this table summarizes the results for performance measured in terms of return on assets (ROA), though the authors use four measures of firm performance: return on assets, return on equity, PE Ratio and Stock return. As will be discussed below, the results vary depending on the measure used.

The paper is interesting as the authors have collected a vast new data set, and the descriptive statistics presented are very interesting. In particular, the data set on interlocking directorships, which shows that about 10 per cent of all directors serve on two or more boards of quoted companies. However this data is not explored further.

However, the study has several weaknesses. Firstly, the study highlights the authors' bias towards the Anglo-American model of governance as it hypothesizes that family owned and managed firms will have poor performance. Though the results of the regression are not significant, the authors do not discuss this result. Secondly, there is an extensive reliance on regression analysis without questioning the robustness of results. The authors do not acknowledge that there is not a single independent variable that is significant in all the four specifications of the regression. When ROA is used as a

dependent variable, the only significant independent variables are the foreign dummy and outside directors variable. Explanatory power of independent variables is taken to be high depending on the number of specifications that the variables are significant for. For example it is argued “..a control variable (dummy variable for foreign CEOs) has the expected positive sign in 2 of the 4 specifications...consistent with prior expectations, board composition (outside directors as a proportion of board size) turns out with a positive sign in each of the four alternative specifications but is significant in only two of them...contrary to expectations, CEO tenure is positive and significant in two out of four specifications (Sanda et al., 2007 pp., 29). The authors then go on to argue “clearly the results are consistent with theoretical expectations, but with some notable exceptions, such as the unexpected finding that CEO tenure encourages performance” (Sanda et al., 2007). Drawing such a strong conclusion from such inconsistent and insignificant results is a leap of faith.²⁴³

This study again highlights the problem of over reliance on regression analysis that is not based on a consistent overall theory but a ‘pick and mix’ combination of different variables that we had discussed extensively in Chapter 3. Furthermore, it highlights the value of qualitative analysis that would have greatly enhanced the understanding of the impact of different governance structures on actually firm performance. For example, qualitative and interview data would have shed light on skill levels of CEOs and explained why long CEO tenure leads to positive performance.

The fourth paper, by Kyereboah-Coleman (2007) looks at the impact of corporate governance on shareholder value maximization in 4 African countries – South Africa, Ghana, Kenya and Nigeria, 103 companies for the period 1997 – 2001 (Kyereboah-Coleman, 2007). The study focuses on three corporate governance measures – size of the board, board independence and CEO duality. The key weakness of the study is that it uses earnings per share and dividend per share to measure performance. These are not the best measure of comparative performance as different companies may have different capital structures and very different numbers of shares.²⁴⁴

²⁴³ At a minimum it would have been useful to have some discussion on how closely correlated the performance of firms as measured by the four different variables actually was.

²⁴⁴ Dividend per share and Earnings per share is an indicator to an individual shareholder of firm performance only when compared with the price earnings ratio of the company and the price paid to acquire each share of the company.

The results are summarized in Table 29.

Table 29: Effect of Corporate Governance on Shareholder Value in Four African Countries 1997 - 2001

Variable	Mean	Minimum	Maximum	Expected Relationship	Actual Relationship
Board Size	9.22	3	23	Negative	Positive
Board Independence	0.41	0.05	0.85	Positive	Inconclusive
CEO duality	0.19	0	1	Positive	Inconclusive

Kyereboah-Coleman (2007)

The descriptive statistics show that:- first, the size of the boards in the sample (South Africa, Kenya, Ghana and Nigeria) is highly diverse with the smallest boards being of three members and the largest of 23 members, second independence of boards is also very diverse though generally most boards are not independent. The average board has 42 per cent non-executive directors and 58 per cent executive directors. Finally it shows that only about 19 per cent of firms in this sample of quoted companies in SSA have separated the position of CEO and Chairman. The regression results of the impact of board independence and CEO duality on performance are inconclusive. Contrary to expectations, board size is positively correlated to performance. The author suggests that this may be because boards members in Africa are not as well remunerated compared to western standards and therefore companies can afford to have larger boards (Kyereboah-Coleman, 2007). However, this argument needs to be backed up with either qualitative or quantitative analysis.

From the overview of the studies of corporate governance in SSA, two main summary points can be raised. Firstly, there is very little evidence for the impact of corporate governance reform on firm performance. Secondly and more importantly, the studies have not engaged critically with the mainstream literature on corporate governance.²⁴⁵ The expected results of hypotheses are based on econometric studies done mainly in the US without an attempt to understand why the results should be the same or different in specific SSA countries. In particular, there is little attempt made to understand how ownership patterns have evolved over time and how, even within a country, different

²⁴⁵ This is in line with the arguments in Chapter 3 which showed the dominance of mainstream methodology and methods in work done on SSA.

firms can have different governance structures. Finally there are not studies that focus on the corporate governance of banks in SSA.

7.6 Corporate Governance of Banks with Focus on Insider Lending

Banks have several peculiar characteristics that make them different from other firms, but there is little guidance as to what conceptual framework is appropriate for analyzing the governance of banks (Caprio & Levine, 2002; Ciancanelli & Reyes-Gonzalez, 2000). Concepts in corporate governance of banks for developed countries have been discussed by Macey and O'Hara (2003) and for developing countries by Arun and Turner (2004). Both papers argue that the peculiar contract form of banking means that it is more appropriate to take a broader view of corporate governance to include depositors as suppliers of finance and extend the fiduciary duties of directors to not only shareholders but also depositors (Arun & Turner, 2004; Macey & O'Hara, 2001). The highly leveraged nature of bank balance sheets, the inherent mismatch between asset liability structures and the state funded deposit insurance schemes in most countries, means that bank directors need to be held to a broader standard of corporate governance (Macey & O'Hara, 2001). Furthermore, as bank failures are costly to the entire economy, we would like to argue that the broadest view of corporate governance is most appropriate.²⁴⁶

All the concepts discussed earlier on ownership structure and corporate governance apply to bank as well. However, in addition it has been argued that the agency problem is even more acute in government owned banks where there is a soft budget constraint (Arun and Turner 2004, Shleifer and Vishny 1997) and owner-managed banks where the incentive for insider lending is high as the profits from the project are fully internalized (Brownbridge, 1998a).

Recalling the discussion on government owned banks in Chapter 4, it was shown that due to political interference, the government owned banks in Kenya have a poor record in terms of non-performing loans. However, as discussed in Chapter 6, due to segmentation of the banking sector, the simple presence or entry of foreign owned banks will not improve the corporate governance practices of government owned banks.

²⁴⁶ Refer to the discussion on definitions of corporate governance in the introduction to this chapter.

There is broad consensus that banks in developing countries engage in insider lending or related lending.²⁴⁷ However, there is no consensus on whether insider lending leads to positive or negative economic growth (Cull, Haber, & Imai, 2006; Maurer & Haber, 2007a). There are two contrasting views. The first is the ‘information view’ associated with Naomi Lamoreaux (1994) which argues that related lending is economically efficient in particular when costs of obtaining information are high. The second view, ‘the looting view’, associated with La Porta et al. (2003) argues that insider lending allows bankers to loot their own banks and therefore has a negative impact on growth. We now consider each of these arguments.²⁴⁸

Lamoreaux (1994) argues that insider lending is the key to understanding New England’s early- nineteenth century banking system. An in-depth study of the evolving patterns of bank functions, ownership and loan policies finds that not only was insider lending highly prevalent, it was beneficial to both investors and economic development (Lamoreaux, 1994). Insider lending reduced the costs of information collection for bank (Lamoreaux, 1994). Due to limited capital, families pooled funds and founded banks based on kinship networks and these kinship networks were strong enough to provide stability of the bank (Lamoreaux, 1994).

It should be recognized that insider lending was not the model of lending throughout pre-civil war America. Early commercial banks in New York and Pennsylvania did not follow the insider lending model but practiced ‘outsider lending’. It is argued that though these banks used a different lending model, they were as effective as New England banks in inducing economic development. Outsider lending practices developed in part because shares of banks were widely held but also because credit information about borrowers was available to the banks (R. Wright, 1998).²⁴⁹

²⁴⁷ The terms insider lending and related lending are used interchangeably in this section. The terms refer to lending by banks primarily to firms controlled by their own directors or their directors’ close friends and family.

²⁴⁸ The debate on related lending is linked to the broader debate on models of corporate governance (discussed above) as related lending is more common in the Eurasian model of governance where there are close ties between banks and borrowers.

²⁴⁹ The comparison of these two studies further emphasize the point stated above that ownership patterns arise from complex historical social and economic processes.

The study of related lending in Mexico in different periods also provides evidence for both the views. Using data from the Mexico bank crisis of 1995-1998 it has been shown that loans to insiders were given on more favorable terms than outsiders.²⁵⁰ Furthermore, default rates on related party loans were 35% higher and recovery on related party loans 30% lower than unrelated party loans (La Porta et al., 2003). They argue this is evidence that related lending is a form of looting by bank directors and that related lending was one of the key reasons for the banking crisis in Mexico (La Porta et al., 2003). In contrast a study of Mexican banks from 1888-1913 shows that related lending was highly prevalent during this time as well, but that the effects of this related lending were not pernicious as banks were highly profitable and the number of bank failures was insignificant (Maurer & Haber, 2007a).²⁵¹ More interestingly, it is shown that banks did attempt to practice arms length lending in 1884 but due to high defaults they were forced to change strategy and lend to insiders (Maurer & Haber, 2007a). Therefore in line with Lamoreaux they argue that:

“Related lending, in effect, provided an informal means to assess risk *ex ante* and enforce contracts *ex post*”

Maurer & Haber (2007a pp., 554)

It should be recognized that a key assumption of La Porta *et al.* (2003) is that bankers follow the short term strategy of looting their own banks as the share of their profits in their own borrowing is more than the share of profits in their own banks. Yet this assumption is not borne out any specific evidence. As will be discussed below there are certain conditions under which looting is more or less likely.

Studies on insider lending in SSA are scant. One study from Uganda finds support for both the looting and the information view (Habyarimana, 2005). The author considers data on 219 Ugandan firms and matches it with local knowledge about ownership links between these firms and two banks that failed – Greenland Bank and Co-operative

²⁵⁰ After controlling for loan and borrower characteristics it is found that loans to related parties benefited from lower interest rates of between 415-420 basis points, longer maturities and lower collateral levels than outsiders (La Porta et al. 2003).

²⁵¹ Examples of the extent of insider lending include data from Banco Mercantil de Veracruz which indicate that 86 per cent of loans to individuals from 1898 to 1906 went to the bank’s own directors (Maurer & Haber, 2007a).

Bank.²⁵² Firms are categorized as ‘affected firms’ if they lost a banking relationship and ‘unaffected’ if they did not have a relationship with the bank. ‘Affected’ firms are further divided into ‘insiders’ or ‘outsiders’ if they had ownership connections with the banks. He finds evidence for the looting view as insider firms experienced the sharpest decline in employment relative to all affected firms. Interestingly however, he also finds evidence for the information view, as even within ‘outsider’ firms, older firms and firms that did not submit audited accounts to the bank but relied on ‘soft information’ held with banks also experienced the largest declines in employment (Habyarimana, 2005).²⁵³

All these studies point to the need to recognize two points. First, looting is not a necessary outcome of insider lending but further research is needed to understand the conditions under which insider lending is destructive and the conditions in which it is not (Maurer & Haber, 2007b). From the case of New England the deeper question that arises is: under what conditions are kinship ties stable or unstable? From the Mexican example it has been postulated that a system with high capital adequacy ratios and ownership structures where all directors own significant equity stakes are some of the conditions under which insider lending may not be pernicious. Second, with specific reference to the discussion on corporate governance reform, it points to the need to recognize that not all owner-managed or family owned banks are prone to looting.

²⁵² Data is from the World Bank’s 2002 / 2003 RPED survey. Greenland Bank was a private, locally owned bank and in 1998 the fifth largest bank in Uganda. In September 1998, it signed a Memorandum of Understanding with the Central Bank – Bank of Uganda (BOU) to inject more capital and reduce the level of insider lending. However, in December 1998 the BOU discovered that the privatization of Uganda Commercial Bank, the largest commercial bank, had misfired. Greenland Bank had illegally acquired control of Uganda Commercial Bank. The BOU took over management of Greenland Bank and closed it four months later. Co-operative Bank the second largest bank in Uganda was recapitalized in 1997 / 1998 using aid from the United States Agency for International Development (USAID). Citing large losses and poor management, USAID withdrew support for the bank in May 1999 and it was promptly closed (Habyarimana, 2005).

²⁵³ Habyarimana uses the same definition of soft vs. hard information that we used in Chapter 6. Therefore, ‘soft information’ includes information cannot be reduced to a set of numbers and therefore this information is lost when a client loses a banking relationship (Habyarimana, 2005). It should be noted that his definition of the ‘information view’ is slightly different from that of Lamoreaux (1994). In this case it is providing evidence for the function of banks as repositories of information in particular soft information. The Lamoreaux (1994) definition is more specifically linked to insider lending where it is argued that banks engage in insider lending as the costs of obtaining information on outsiders is too expensive.

As discussed in Chapter 1, it was impossible for the author of this thesis to get information on insider lending practices of banks in Kenya. Therefore the next chapter, which looks at corporate governance practices of banks in Kenya, does not specifically discuss insider lending. However drawing from the literature above, the discussion in Chapter 8 is based on the view that owner-managed banks should not be viewed purely as vehicles of looting.

7.7 Concluding Remarks

This chapter provided a conceptual background and synthesis of the corporate governance literature. It emphasized that there are several unresolved debates both at the theoretical and empirical level. It emphasized that ownership structures and corporate governance practices are products of complex historical social and economic practices and that it is impossible to specify *a priori* which structures are optimal for firm or bank performance. The arguments echo recent heterodox research that has confirmed the existence of a wide variety of ownership and control structures throughout the world and warns against a discussion of corporate governance in terms of absolutes (Sun, 2003; Tobin & Singh, 2008). Therefore it is imperative to understand country specific and time specific institutional and social structures before imposing ‘best practices.’

The chapter also considered studies on the impact of specific board practices on firm performance, and again showed that there is very little empirical consensus on ‘best practice’. At this stage, it is also useful to recall the methodological arguments discussed in Chapter 1 and 2 on open systems analysis versus closed system analysis. It is not surprising that many of these studies do not give conclusive results as each measure – for example CEO/Chair separation – will be just one variable affecting firm performance and there are many other variables, including some that are very difficult to quantify, that also affect firm performance.

The chapter also highlighted that due to the special nature, of banks in particular the fiduciary duty of directors to depositors, and corporate governance of banks is extremely important to understand. The chapter also discussed the debates regarding insider lending in banks and showed that owner-managed banks should not be viewed

solely as agents of looting and that well capitalized owner-managed banks are less prone to looting.

Methodologically, the studies point to the need to combine qualitative and quantitative data to truly understand the nature and evolution of corporate governance. Furthermore, through a critical analysis of studies on corporate governance in SSA, this chapter showed that the data on corporate governance in SSA is limited, of very short time scale and focused on quoted companies with very little effort made to collect data for unquoted companies or banks. Therefore, there is value in collecting new and detailed data sets on corporate governance of both quoted and unquoted companies and this thesis has collected data on the corporate governance of banks in Kenya. This data is discussed in the next chapter. It is hoped that the detailed analysis of corporate governance of banks in Kenya with its attempt to use both qualitative and quantitative data and its focus on the segmentation of the market will move the literature forward.

CHAPTER 8 – CORPORATE GOVERNANCE: THE EXPERIENCE OF THE BANKING SECTOR IN KENYA

8.1 Introduction

While the objectives of good corporate governance are relatively clear – it is hard to argue against better-run firms or banks - the means of achieving these objectives is still unclear. This chapter focuses on the experience of Kenyan banks with corporate governance reform.²⁵⁴ Section 8.2 outlines the ownership and management structure of the banking system in Kenya with a focus the concentration of ownership (which as discussed in Chapter 7 is seen as a key determinant of agency problems). In Section 8.3, the regulation for corporate governance of banks in Kenya is analyzed – particularly the similarities and differences with international codes. Using qualitative and quantitative data, Section 8.4, gauges the extent to which there is compliance to corporate governance regulation among the different segments and assess the possible reasons for non-compliance. Section 8.5 also discusses international corporate governance principles that have not been adopted by the Central Bank of Kenya and whether it would be useful to adopt these. In Section 8.6, the chapter draws conclusions on the impact of corporate governance regulation on the performance of banks in different segments of the banking sector in Kenya.

8.2 Ownership and Management Structure of Banks in Kenya

In Chapter 4 we had discussed the ownership structure of the banking sector in terms of the different segments – FOB, GOB, LPOB and SPOB, and also by ethnicity of ownership. We showed that the structure is a result of complex historical social and economic processes. Table 30 extends the data in Chapter 4 by highlighting the concentration levels of ownership of banks in Kenya. As discussed in Chapter 7 while ownership concentration is seen to be a key variable determining corporate governance of firms, it is still highly debated whether concentrated share ownership or diffused share ownership is better for firm performance. Table 30 shows that concentrated share

²⁵⁴ As noted in Chapter 1, this thesis focuses on three relationships in banking – lending, deposit mobilization and corporate governance. This chapter discusses the last of these relationships. Refer to the research questions stated in Chapter 1, Section 1.1.5.

ownership is the predominant form of share ownership even amongst foreign owned banks and large private owned banks. Concentrated share ownership is the predominant feature even amongst banks that are quoted on the Nairobi Stock Exchange. Diffused shareholding is quite rare. The only LPOB with diffused shareholding is the Co-operative Bank of Kenya, which is a very unique institution whose shareholders consist of the all the Co-operative societies in Kenya. In the case of SPOB, there are two banks with diffused shareholding - Oriental Commercial Bank and City Finance Bank. The current shareholders were formerly depositors who converted their deposits to equity to ensure the reopening of the bank once it had been placed under statutory management. Therefore the current diffused share ownership was not a strategic choice made by the shareholders.

Furthermore, minority shareholding (less than 10% shareholding) is also rare among banks in Kenya. The banks quoted on the stock exchange, do have minority shareholders.²⁵⁵ These are individual private investors that have purchased shares on the stock exchange.²⁵⁶ Amongst the private banks, minority shareholders have come into existence almost by accident. I&M Bank and Southern Credit Bank have minority shareholders due to the mergers with Biashara Bank and Bullion Bank respectively.²⁵⁷

In summary, the ownership structure of banks in Kenya is therefore more closely aligned to the Eurasian model of ownership rather than the Anglo-American model of ownership. The implication of the data in the table is that any corporate governance regulation that is adopted in Kenya has to take into account this ownership structure. As will be discussed below some of corporate governance regulation attempts to enforce regulation that is not appropriate for this ownership structure.

²⁵⁵ The banks quoted on the stock exchange are Barclays Bank, Standard Chartered Bank, Kenya Commercial Bank, National Bank of Kenya, NIC Bank, CFC Bank.

²⁵⁶ However, ownership is still highly concentrated. In the case of FOB the majority shareholder is the parent foreign bank, for GOB the Government of Kenya and for LPOB a group of individuals or an institution.

²⁵⁷ Biashara Bank had been started by the Oshwal Community and for all its community members and had a diffused shareholding. After the merger with I&M, this block of diffused shareholders have become a minority in the shareholding. Bullion Bank also had diffused shareholders after depositors converted their deposits to equity in 2000, to revive the bank, after it had been placed under CBK statutory management in 1998. After the merger with Southern Credit Banking Corporation in 2002, this block of diffused shareholders became minority shareholders.

Table 30 : Ownership Structure of Bank in Kenya 2005 including Details on Ownership Concentration

	Bank	Segment	Shareholder Details	Ethnicity Of Owners	Quoted on NSE	Concentrated or Diffused Share Ownership	Ownership	Owner - Managed
1	Barclays Bank of Kenya	FOB	Barclays Bank Plc Ltd (majority)	Not relevant	Yes	Concentrated	Institutional	NO
2	Standard Chartered Bank	FOB	Standard Chartered Bank Plc (majority)	Not relevant	Yes	Concentrated	Institutional	NO
3	Citibank N.A.	FOB	branch of Citibank N.A.	Not relevant		Na	Institutional	NO
4	Stanbic Bank	FOB	Standard Bank South Africa	Not relevant		Concentrated	Institutional	NO
5	Bank of Baroda	FOB	Bank of Baroda India (owned by Government of India) (majority)	Indian		Concentrated	Institutional	NO
6	Bank of India	FOB	branch of Bank of India (owned by Government of India)	Indian		Na	Institutional	NO
7	Bank of Africa Kenya	FOB	Bank of Africa Benin, Bank of Africa Madagascar and Netherlands, Development Finance Company	Not relevant		Concentrated	Institutional	NO
8	Habib A.G. Zurich	FOB	branch of Habib Bank A.G. Zurich	Pakistani		Concentrated	Single Family Owned	YES
9	K-Rep Bank	FOB	IFC, NGOs and K-Rep group	Not relevant		Concentrated	Institutional	NO
10	Habib Bank Ltd	FOB	Aga Khan Fund for Economic Development and Government of Pakistan	Pakistani		Concentrated	Institutional	NO
11	Kenya Commercial Bank	GOB	Government of Kenya, National Social Security Fund	Not relevant	Yes	Concentrated	GoK	NO
12	National Bank of Kenya	GOB	Government of Kenya	Not relevant	Yes	Concentrated	GoK	NO
13	Consolidated Bank	GOB	Government of Kenya	Not relevant		Concentrated	GoK	NO
14	Development Bank of Kenya	GOB	Government of Kenya	Not relevant		Concentrated	GoK	NO
15	Co-operative Bank of Kenya	LPOB	Over 3,000 Co-operative Societies	Not relevant		Diffused	Institutional	NO
16	CFC Bank	LPOB	Mr. Jani, Mr. Njonjo, Mr. Kirenie, Mr. Kulei (through	Asian-African and African	Yes	Concentrated	Individuals	YES

	Bank	Segment	Shareholder Details	Ethnicity Of Owners	Quoted on NSE	Concentrated or Diffused Share Ownership	Ownership	Owner - Managed
			holding companies)					
17	Commercial Bank of Africa	LPOB	Kenyatta family, Rai family and Naushad Merali family	Asian-African and African		Concentrated	Individuals	YES
18	NIC Bank	LPOB	Ndegwa family	African	Yes	Concentrated	Individuals	YES
19	I&M	LPOB	S. Raja family	Asian-African		Concentrated	Family Owned	YES
20	Diamond Trust	LPOB	Aga Khan Fund for Economic Development, Allied Irish Bank	Asian-African	Yes	Concentrated	Institutional	NO
21	Equity Bank	LPOB	Britac Insurance Co, IFC, James Mwangi	African	Yes	Concentrated	Institutions & Individuals	YES
22	Imperial Bank	LPOB	Popat Family, Shah (Rex Motors) family, Somji (Freight Forwarders family)	Asian-African		Concentrated	Individuals	YES
23	Trans-National Bank	LPOB	Mr. Gideon Moi, Mr. Kulei	African		Concentrated	Individuals	NO
24	EABS Bank	SPOB	Pandit Family	Asian-African		Concentrated	Family Owned	YES
25	Fina Bank	SPOB	D. Chandaria family, Patel ('Sparrow') family	Asian-African		Concentrated	Individuals	YES
26	Prime Bank	SPOB	A. Kantaria family	Asian-African		Concentrated	Family Owned	YES
27	ABC Bank	SPOB	A. Savani family	Asian-African		Concentrated	Family Owned	YES
28	Giro Commercial Bank	SPOB	P. Gidoomal family	Asian-African		Concentrated	Family Owned	YES
29	Guardian Bank	SPOB	M. Chandaria family	Asian-African		Concentrated	Family Owned	YES
30	Southern Credit Bank	SPOB	A. Kurji family and several minority shareholders	Asian-African		Concentrated	Family Owned	YES
31	Charterhouse Bank Ltd.	SPOB	Shah (Kingsway) family, Ehsani family, Shah (Nakumatt) family, Harun Mwau	Asian-African and African		Concentrated	Individuals	NO
32	Victoria Commercial Bank	SPOB	Y. Pattni Family	Asian-African		Concentrated	Individuals	YES
33	Middle East Bank	SPOB	Esmail family, Biwott family, Banque Belgolaise	Asian-African and African		Concentrated	Individuals	NO
34	Equatorial Commercial	SPOB	Naushad Merali family	Asian-African		Concentrated	Individuals	NO

	Bank	Segment	Shareholder Details	Ethnicity Of Owners	Quoted on NSE	Concentrated or Diffused Share Ownership	Ownership	Owner - Managed
	Bank		and Gideon Moi family	and African				
35	Credit Bank	SPOB	S. Nyachae family	African (Kisii)		Concentrated	Individuals	NO
36	Chase Bank	SPOB	Alibhai Shariff family, Azim Virjee family, Vohra family	Asian-African		Diffused	Individuals	YES
37	Fidelity Commercial Bank	SPOB	Sultan Khimji, Murli Sadwani, Bharat Thakrar, Equity Investments, Firoz Manji and N. P. Sheth and 21 other shareholders	Asian-African		Diffused	Individuals	YES
38	Paramount Universal Bank	SPOB	Merali and Dodhia families.	Asian-African		Concentrated	Individuals	YES
39	Oriental Commercial Bank	SPOB	depositors became owners after restructuring	Asian-African		Diffused	Individuals	NO
40	Dubai Bank (formerly Mashreq Bank)	SPOB	Zubedi family	Arab (Swahili)		Concentrated	Family Owned	YES
41	City Finance Bank	SPOB	depositors became owners after restructuring	Asian-African		Diffused	Individuals	NO

Source: Corporate Governance Database collected by the Author

Note: Na stands for not applicable as the bank is a branch of the parent bank

8.3 Regulation of Corporate Governance of Banks in Kenya

We now turn to the regulation of corporate governance of banks in Kenya. First, we discuss two international corporate governance codes – The OECD Corporate Governance Principles and the Basel Principles. Then we discuss the corporate governance regulations in Kenya.

8.3.1 OECD and Basel Principles

The OECD Corporate Governance Principles consist of six principles that help governments put in place regulations to enhance corporate governance of companies.

The principles are:-

- OECD Principle 1 - Ensuring the basis for an effective corporate governance framework - The corporate governance framework should promote transparent

and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

- OECD Principle 2 - Rights and duties of shareholders - The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
- OECD Principle 3 - The equitable treatment of shareholders - The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- OECD Principle 4 - Establish a role for stakeholders in corporate governance - The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- OECD Principle 5 - Ensure suitable levels of disclosure and transparency - The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- OECD Principle 6 - The fulfillment of responsibility of the board of directors - The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Organization for Economic Co-operation and Development (2004).²⁵⁸

The OECD principles are amongst the broadest that have been developed throughout the world. It is important to recognize that the OECD principles represent a compromise between the Anglo-American and the Eurasian models on what constitutes best practice (Baker, 2008; Tobin & Singh, 2008). The Preamble of the OECD Principles states that they “do not aim at detailed prescriptions for national legislation.

²⁵⁸ The first version of the Principles was endorsed by OECD ministers and published in 1999 (Organisation for Economic Co-operation and Development, 2004).

Rather, they seek to identify objectives and suggest various means for achieving them” (Organisation for Economic Co-operation and Development, 2004).

The second bank specific guidelines have come from the Basel Committee. As part of the Basel II process, Basel Core Principles on Effective Supervision also specify corporate governance measures. There are 25 principles but the specific ones that related to corporate governance are:-

- Basel Principle 3 - Licensing criteria – The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained
- Basel Principle 4 – Transfer of ownership - The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
- Basel Principle 11 – Exposures to related parties - In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm’s length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Bank for International Settlements (BIS) (2006).²⁵⁹

Like the OECD principles, these Basel principles are broad and can be applicable to either the Anglo-American or Eurasian corporate governance frameworks.

As part of the Financial Sector Assessment Programs (FSAPs), the World Bank and IMF have begun since 1999 to produce Reports on the Observance of Standards and

²⁵⁹ The Core Principles for Effective Supervision were first published in 1997 and the revised version in 2006.

Codes (ROSCs) and therefore compliance by governments to these codes is strongly encouraged.²⁶⁰ This has been referred to as the ‘standard-surveillance-compliance’ system of the Post Washington Consensus (Wade, 2007). In response to these developments, the CBK has introduced corporate governance guidelines for banks in Kenya.

8.3.2 Central Bank of Kenya Guidelines

The CBK corporate governance guidelines were first introduced in 2000. It is referred to as CBK/RG/08 and forms pages 112 to 123 of the Prudential Guidelines for 2000 (henceforth referred to as the ‘2000 CBK Guidelines’). The 2000 CBK Guidelines were relatively simple and focused on the duties of directors. The latest set of guidelines is extremely extensive and was issued in 2006 to replace the 2000 CBK Guidelines. It is referred to as CBK/PG/02 and it forms pages 27 – 47 of the Prudential Guidelines for 2006. Henceforth it will be referred to as the ‘2006 CBK Guidelines.’ The CBK states that the rationale for the introduction of the regulation is to establish ‘*best practice*’ in corporate governance (Central Bank of Kenya, 2005). As we had discussed in Chapter 7, it is very difficult to specify, a priori, what corporate governance ‘best’ practices are. However, it will be shown below that the Central Bank of Kenya corporate governance regulations do not take this debate into account.

The Capital Markets Authority (CMA) in Kenya has also issued guidelines for all companies quoted on the NSE. The guidelines were issued in 2002 and been given legal status through an amendment of the Capital Markets Act section 485A. Therefore banks that are quoted on the NSE follow both the CBK and the CMA corporate governance guidelines. In general, there is concurrence with the CMA and the CBK guidelines.²⁶¹

²⁶⁰ The foreword to OECD Principles of Corporate Governance states “The Financial Stability Forum has designated the *Principles* as one of the 12 key standards for sound financial systems. The *Principles* also provide the basis for an extensive programme of cooperation between OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes (ROSCs)” (Organisation for Economic Co-operation and Development, 2004).

²⁶¹ One of the main points of difference is that the CMA guidelines require companies to state the top ten shareholders in their annual report and the CBK guidelines do not require this. Refer to section on disclosure and transparency for discussion on this anomaly.

It is also interesting to note that New Partnership for Africa's Development (NEPAD), in response to international developments have focused on corporate governance as part of the African Peer Review Mechanism (APRM). In 2005 and 2006, Kenya participated in the as part of the APRM and the NEPAD report contains an assessment of the standards of corporate governance practices in Kenya in comparison to international benchmarks.

Table 31: Corporate Governance Requirements by the CBK 2006

OECD Principle / BIS (Basel) Principle for Supervision	Related Requirement in CBK 2006 CBK Guidelines
Separation of Ownership and Control (not based on any specific OECD / Basel Principle)	A shareholder with more than 5% of shareholding cannot be in management or hold an executive directorship
OECD Principle 1 - Effective basis for corporate governance framework	No specific regulation
OECD Principle 2 - The Rights and Duties of Shareholders	Shareholders should appoint competent board, monitor board activities and use AGM to remove directors who are not performing.
OECD Principle 3 - The Equitable Treatment of Shareholders	No specific guideline
OECD Principle 4 - The Role of Stakeholders in Corporate governance	No specific guideline
OECD Principle 5 - Suitable levels of Disclosure and Transparency	Quarterly publishing of annual reports in national newspapers

OECD Principle / BIS (Basel) Principle for Supervision	Related Requirement in CBK 2006 CBK Guidelines
OECD Principle 6 - Fulfilment of Responsibility by the Board of Directors	<ul style="list-style-type: none"> • Long list of duties of directors given including participating in and chairing board committees (See Appendix 21) • Board Independence -executive Directors should be less than 30% of the board. The majority of non-executive directors should be independent • CEO duality - Separation of position of CEO and chairman of the board. Chair must be a non-executive director • Necessity to set and defined roles of several committees including:- Board Audit Committee, Board Credit Committee, Asset and Liability Committee (ALCO), Risk Management Committee, Executive Committee • Board Audit Committee and Board Credit Committee should be chaired by a non-executive director • Annual review of board done through peer and self evaluation and guidelines specified and sent to CBK by 31st March of the following year
Basel Principle 3 – Licensing Criteria	Shareholders and Directors vetted by the CBK
Basel Principle 4 – Transfer of Ownership	Change in more than 5% of an institutions share capital requires permission of the CBK, and vetting of the shareholders by CBK
Basel Principle 11 - Exposures to related parties (Insider Lending)	<ul style="list-style-type: none"> • No unsecured lending to directors or employees • Any secured lending must be approved by the whole board and also given on same terms as other clients

8.4 Compliance with Central Bank of Kenya Guidelines

This section discusses the behaviour and responses of banks to the corporate governance guidelines and assesses whether the guidelines will have the desired impact of improving the performance of the banking sector in Kenya.²⁶² The main data analyzed here are qualitative data collected from semi-structured interviews of 7 banks and also quantitative data collected from the financial statements of all banks in Kenya in 2005.²⁶³ This section discusses compliance with the following regulations: -

- Separation of ownership and management
- Responsibility of Board of Directors
- Independence of Board of Directors
- CEO duality and Committee Structures
- Vetting of Directors
- Transparency and disclosure
- Insider Lending

Table 32 summarizes the qualitative data on the constraints faced by different segments of the banking sector in Kenya in complying with these regulations.

Table 32: Corporate Governance Characteristics and Constraints in Complying with Regulations by Segments

	Segment	FOB	GOB	LPOB	SPOB
	No of Banks Interviewed in Segment	1 (Bank 1)	1 (Bank 2)	3 (Bank 3, Bank 4, Bank 5)	2 (Bank 6, Bank 7)
	Quoted on Stock Exchange	Bank 1 - YES	Bank 2 - YES	Bank 3 - NO Bank 4 - YES Bank 5 - YES	Bank 6 - NO Bank 7 - NO

²⁶² The effective date for these guidelines was 1st January 2006 and therefore several banks took these guidelines into account when publishing the accounts for end of year 2005 in early 2006. Furthermore, as stated in Chapter 1, interviews were conducted in summer of 2006, and the guidelines were fresh in the minds of persons interviewed.

²⁶³ There are several limitations of both the qualitative and quantitative data in the particular the inability to get any reliable information on insider lending. Refer to Chapter 1 for the details on data limitations.

	Segment	FOB	GOB	LPOB	SPOB
	No of Banks Interviewed in Segment	1 (Bank 1)	1 (Bank 2)	3 (Bank 3, Bank 4, Bank 5)	2 (Bank 6, Bank 7)
1	Concentrated Shareholding	YES	YES	YES	YES
2	Separation of Ownership and Management	YES	YES	NO	NO
3	Presence of Minority Shareholders	YES	YES	Bank 3 - NO Bank 4 - NO Bank 5 - YES	Bank 6 - NO Bank 7 - YES
4	Changes in Board Structure to Comply with Rule on Separating Ownership and Management	N/A	N/A	YES, but also evidence of symbolic compliance	YES, but also evidence of symbolic compliance
5	Human resource constraint in getting directors	NO	NO	YES	YES
6	Effectiveness of publishing financial data in the newspapers	NO	NO	NO	NO

8.4.1 Separation of Ownership and Management

This regulation specifies that a shareholder with more than a 5% shareholding in a bank cannot hold an executive position in that bank. As it was also noted in Table 31, this regulation does not have its roots in either the OECD or Basel principles.²⁶⁴ It can be discerned that it is implicitly based on the Anglo-American governance model, which emphasizes the separation of ownership and management. As discussed in Chapter 7,

²⁶⁴ However, the CBK enforces this regulation based on Basle Core Principle 4, in which transfer of ownership requires the permission of CBK.

the ‘crony capitalism’ school links high ownership concentration to the Asian financial crash of 1997. It is also implicitly based on the looting view of owner managed banks of La Porta et al. (2003) and therefore attempting to control the behavior of owner-managed banks.²⁶⁵

As shown in Table 30 the ownership structure of the banking sector in Kenya is highly concentrated and therefore closer to the Eurasian model of governance discussed in Chapter 7.²⁶⁶ Furthermore, family ownership and owner-management is a common feature of most privately owned banks.

Therefore it is not surprising that this regulation has proven to be extremely controversial for banks in LPOB and SPOB segment. This regulation had no effect on FOB and GOB banks. Among the banks interviewed there was a consensus that this guideline was largely targeted at owner-managed banks. The respondents noted that contrary to perception no all owner-managed banks were badly run.

“But the tribute for where our bank is today must go to our founding shareholder, the late Mr. XXX. Even though Mr. XXX was a 25% shareholder he ran the bank better than other organizations are run. He was a proper banker, therefore even though Mr. YYY, a politician was also a shareholder, there were no political loans given by our Bank” Bank 4, LPOB, quoted

Furthermore the respondents indicated that it was not clear that the existence of such a guideline - enforcing separation of ownership and management - could have prevented the failure of banks prior to 2005. Contrarily they argued that it was essential that owners remain involved in the operations of the bank to ensure good performance:

“We are trying to meet international best practices so we already have in place new recommendations by CBK. But sometimes the corporate governance rules can go too far. If the owners do not keep a track of the

²⁶⁵ Refer to discussions in Chapter 7, Section 7.3 and Section 7.6.

²⁶⁶ Referring to Chapter 7, Table 1, the Kenyan banking system is also closer to the Eurasian model of corporate governance in terms of other indicators, including, low stock market capitalization to GDP ratio and banks being the major source of financing.

bank operations, then it will go down. Just because some owners looted their banks does not mean all owners will loot” Bank 5, LPOB

Interview data indicated that particularly amongst the SPOB segment, changes in shareholding have been taking place by banks to ensure compliance with the guidelines. For example, a shareholder who wanted to remain in an executive position transferred part of his shareholding to his brother to stay within the 5% threshold.

“Mr. XX himself had to reduce his shareholding from 10% to 5% to remain executive director as per CBK guidelines” Bank 7, SPOB

This is an example of ‘symbolic’ compliance. Therefore this regulation may not have the impact it was intended to have, as executive directors may still have an indirect controlling interest in a bank.

Furthermore, there have also been notable exceptions to the enforcement of this regulation by CBK. For example, Equity Bank’s managing director Mr. James Mwangi owns a 7.3% in the bank with a further beneficial shareholding of 0.74% based on his ownership of an investment company which is also a shareholder in the bank (Gikunju, 2007).²⁶⁷ Therefore, he is above the 5% threshold. In August 2006, when Equity Bank was listed on the Nairobi Stock Exchange the managing director was given a one year exemption from this rule (Gikunju, 2007). This exemption again highlights the problem of enforcing regulation that is attempting to enforce separation of ownership and management onto a system where ownership is highly concentrated. Furthermore, other banks may also apply for exemption on the grounds of fairness and the ability of the CBK to uphold this particular section of the 2006 CBK Guidelines is seriously questionable.

In summary, this regulation does not take into consideration the reality of the ownership structure of banks in Kenya. Enforcing this separation of ownership and management when the ownership is highly concentrated will lead to non-compliance or symbolic compliance and will not necessarily lead to improved performance of banks.

²⁶⁷ Equity Bank was not part of the interview sample and the discussion above is based on public sources. Therefore the name of the bank is stated instead of referring to it as Bank1, Bank 2 etc.

8.4.2 Responsibility of Board of Directors

The 2000 CBK Guidelines contains very general guidelines for directors, chief executives and management.²⁶⁸ The most significant part of the guidelines is that it specifies that the board should constitute an Audit Committee with a written charter, a non-executive director as its chairman (CEO duality) and regular reporting to the board (Central Bank of Kenya, 2000b).²⁶⁹ The 2006 CBK Guidelines are extensive and laid out in Table 31 and Appendix 21.

This guideline is linked to OECD Principle 6 which recognizes the diversity of board structures around the world and states “...do not advocate any particular board structure and the term ‘board’ as used in this document is meant to embrace the different national models of board structures found in OECD and non-OECD countries” (Organisation for Economic Co-operation and Development, 2004 pp., 15). However the 2006 CBK Guidelines have emphasized a more Anglo-American approach, with focus on independence of non-executive directors, CEO duality and the setting up of board committees. It should be noted that while the ownership structure of banks in Kenya is highly concentrated and can be said to be similar to the Eurasian ownership structure, board structures in Kenya historically follow English common law and therefore are similar to the system of single boards of the Anglo-American governance mechanisms. The directors are representatives of the shareholders and not all stakeholders. Chapter 7 showed that the empirical evidence of the impact of board reforms on performance from other countries is very mixed. As board reforms in the Kenyan banking sector were introduced just before the fieldwork was carried out, it is difficult to judge the impact of the latest reforms on performance, but an initial analysis is carried out.

Table 33 shows the total number of directors of each bank in Kenya and also the total number of executive directors, and the ratio of executive directors to total directors. The analysis shows that the average size of bank boards in Kenya is 8. For GOB the average is the highest at 10 and for SPOB it is smallest at 6. For FOB and LOPB the

²⁶⁸ The 2000 CBK Guidelines for directors include a list of responsibilities such as regulate manner in which business is conducted, corporate planning, avoid self-serving practices and maintain adequate capital base amongst others.

²⁶⁹ In the cases of banks where there is no local board, the internal audit function is required to report directly to chief appointee from the head office (Central Bank of Kenya, 2000b).

average board size is 9. This can be compared to the average board size for quoted companies in Kenya of 10 quoted in the study of Ayogu (2001). As discussed in Chapter 7, there is very little conclusive empirical evidence linking board size to performance. We had argued that studies that simply link small board size to positive performance are misguided. Therefore, the 2006 CBK Guidelines are enlightened, as they do not try to specify a standard board size for all bank boards in Kenya.²⁷⁰

Table 33: The Structure of Boards of Banks in Kenya

	Bank	Segment	No Of Total Directors	No Of Executive Directors	Exec Director As % Of Total Directors
1	Barclays Bank of Kenya	FOB	10	3	30%
2	Standard Chartered Bank	FOB	11	5	45%
3	Citibank N.A.	FOB	NA	NA	
4	Stanbic Bank	FOB	9	6	67%
5	Bank of Baroda	FOB	10	4	40%
6	Bank of India	FOB	NA	NA	
7	Bank of Africa Kenya	FOB	5	1	20%
8	Habib A.G. Zurich	FOB	NA	NA	
9	K-Rep Bank	FOB	11	1	9%
10	Habib Bank Ltd	FOB	NA	NA	
11	Kenya Commercial Bank	GOB	11	2	18%
12	National Bank of Kenya	GOB	13	3	23%
13	Consolidated Bank	GOB	7	1	14%
14	Development Bank of Kenya	GOB	9	1	11%
15	Co-operative Bank of Kenya	LPOB	16	1	6%
16	CFC Bank	LPOB	11	3	27%
17	Commercial Bank of Africa	LPOB	6	2	33%
18	NIC Bank	LPOB	9	2	22%
19	I&M	LPOB	6	1	17%
20	Diamond Trust	LPOB	10	1	10%
21	Equity Bank	LPOB	12	1	8%
22	Imperial Bank	LPOB	7	1	14%

²⁷⁰ However, they state that the minimum board size should be 5 directors (Central Bank of Kenya, 2006b).

	Bank	Segment	No Of Total Directors	No Of Executive Directors	Exec Director As % Of Total Directors
23	Trans-National Bank	LPOB	8	1	13%
24	EABS Bank	SPOB	8	4	50%
25	Fina Bank	SPOB	5	1	20%
26	Prime Bank	SPOB	8	0	13%
27	ABC Bank	SPOB	5	2	40%
28	Giro Commercial Bank	SPOB	5	1	20%
29	Guardian Bank	SPOB	5	1	20%
30	Southern Credit Bank (Merged with Bullion Bank)	SPOB	7	3	43%
31	Charterhouse Bank Ltd.	SPOB	no annual report	no annual report	
32	Victoria Commercial Bank	SPOB	5	1	20%
33	Middle East Bank	SPOB	7	1	14%
34	Equatorial Commercial Bank	SPOB	6	2	33%
35	Credit Bank	SPOB	7	1	14%
36	Chase Bank	SPOB	6	3	50%
37	Fidelity Commercial Bank	SPOB	6	1	17%
38	Paramount Universal Bank	SPOB	4	1	25%
39	Oriental Commercial Bank (formerly Delphis Bank)	SPOB	6	1	17%
40	Dubai Bank (formerly Mashreq Bank)	SPOB	6	1	17%
41	City Finance Bank	SPOB	5	1	20%
	Average		8	2	24%

Source: - Author's calculations

Notes: - NA – These banks are branches of their parent banks therefore do not have a board of directors

In general FOB are viewed as having the 'best' corporate governance practices as they are already following international benchmarks. The analysis revealed that within the FOB segment in Kenya, there are governance differences. Some of the FOB are structured as branches of the parent bank and therefore do not have a board in Kenya. This includes Citibank and Bank of India. Others are incorporated in Kenya with the majority of shares owned by the foreign bank for example Barclays Bank and Standard Chartered Bank and have a local board in Kenya. The Kenyan board members of FOB

are recognized as highly qualified and the extremely well respected professionals and entrepreneurs. However, fieldwork revealed that even FOB with local boards operate more like branches of the parent bank and therefore do not meet the 2006 CBK corporate governance guidelines in particular that the board should take ultimate responsibility for the bank:

“In most cases our compliance and our internal guidelines are more onerous than CBK. If there is a clash between the board and the internal guidelines on a credit, it is normally the internal guidelines that will ‘win’ as the credit has to be approved by head office. Yes, you could say that the board credit committee operates more as a rubber- stamping tool. But that does not mean we don’t have good governance. If a credit has met the approval of our internal guidelines, it has gone through a rigorous process. A board member sometimes just questions the credit based on rumour about the party.” Bank 1, FOB, quoted

This section highlights that there may be non-compliance with the CBK regulations which state that the board credit committee has to bear ultimate responsibility for the credit decisions. While a system where the final credit decision lies with the head office may not lead to poor performance of the bank, the interview highlights the need for CBK regulations to be revised to take into account these differences.

8.4.3 Independence of Board of Directors

The 2006 CBK Guidelines state that executive directors should not form more than 30% of the board. As discussed in Chapter 7, the logic for this guideline is that ‘non-executive’ or ‘independent’ directors are viewed as more likely to act in shareholders’ interests compared to ‘inside’ or executive directors as they do not have incentives to collude with internal managers to expropriate shareholders (Fama & Jensen, 1983; Monks & Nell, 2004). However, as discussed in Chapter 7, the empirical evidence on the benefits of non-executive is very mixed.²⁷¹ The two studies on African (Nigerian) firms get differing results. Sanda *et al.* (2005) finds that outside directors variable is not significant, while Sanda *et al.* (2007) finds the variable is positive and significant.²⁷²

²⁷¹ Refer to Chapter 7, Section 7.2.4.

²⁷² Refer to Chapter 7, Section 7.6.

As shown in Table 33, there are eight banks that do not meet this criterion and will have to make adjustments to comply. These banks are from all the four segments of the banking sector, therefore, one cannot argue that the proportion of executive directors is higher in any one segment. However, as will be discussed below, banks in the SPOB segment are finding it harder to comply with these regulations than banks in other segments.

Furthermore, the 2006 CBK Guidelines state that majority of non-executive directors have to be independent. Non-executive directors are defined as those who are not involved in the day-to-day management of the company. While ‘independent’ non-executive directors are defined as those that have not been employed by the institution in an executive position for the last five years, and not linked through family relationships or other business relationships with the institution or its affiliates (Central Bank of Kenya, 2006b). Two points can be made in reference to this: Firstly, while it is easy to count the number of non-executive directors, it is quite difficult to determine the independence of directors. Therefore, the enforcement of this rule leaves considerable discretion to the CBK regulators and higher likelihood of differential enforcement amongst banks. Secondly, in a developing country where the skill base is weak, the skill of the board member is likely to be more useful than independence. For example, NIC Bank, a LPOB is largely held by the Ndegwa family.²⁷³ The non-executive Chairman of the company is Mr. James Ndegwa and his brother Andrew Ndegwa is another non-executive director and therefore clearly not independent. However, both brothers have extremely high academic and professional qualifications that are stated in the annual report. Therefore, a strict enforcement of this regulation by the CBK, on independence of directors, may lead to detrimental outcomes for the bank if these loose skilled directors which are hard to replace.

8.4.4 CEO Duality and Committee Structures

The 2000 CBK Guidelines did not state any requirement for CEO duality. However, in 2003, it was found that 80% of boards of banks had a non-executive chairman (Centre for Corporate Governance Kenya, 2004). By end of 2005, all banks were compliant with the 2006 CBK guidelines, which stipulated CEO duality, and there was no bank that had

²⁷³ NIC Bank is not part of the interview sample and it is quoted on the Nairobi Stock Exchange.

an executive chairman. The interviews indicated that banks in all segments found this guideline useful and did not find it difficult to meet this guideline.

The 2006 CBK Guideline states that is necessary for the board to set up and define the roles of several committees including: - Board Audit Committee, Board Credit Committee, Asset and Liability Committee (ALCO), Risk Management Committee, Executive Committee. Furthermore it states that a non-executive director should chair the Board Audit Committee and Board Credit Committee (Central Bank of Kenya, 2006b). In 2005, all banks had in place an audit committee and a credit committee headed by non-executive directors. Therefore there was complete compliance with this guideline. For comparative purposes, in 2000 only 3 banks indicated in their financial reports that their audit committee and credit committee was headed by a non-executive director. However, the interviews revealed the SPOB found these guidelines costly to implement in terms of time taken for committees to make decisions:

“Sometimes CBK is trying to impose all international practices on banks and this will lead to a stifling of innovation in the bank and banks getting bogged down in cost of numerous committees. Also, as the guidelines place a lot of duties on the directors, to an extent they become *part of management*.. Cost will be justified if CBK actually ensures implementation by all banks”
Bank 6, SPOB

The interviews revealed that the regulations are likely to have contradictory effects. While they are aimed at increasing the independence of the board directors, the requirements for non-executive directors to be involved in several committees, may lead to them becoming closer to management. Therefore, while it is too early to judge the impact of these reforms on firm performance, the interviews revealed that the impact is likely to be mixed and highly dependent on individual directors’ skills and integrity. The Sarbanes Oxley regulation on governance brought in the US after the Enron scandals has been criticized for focusing too much on the monitoring role of directors and not enough on the strategic role of directors (Hertig, 2005). Similar criticisms can be raised about the regulation of boards of banks in Kenya

8.4.5 Vetting of Directors

Following also the Basel Core Principle 3, the CBK 2006 regulations also stipulate that all directors have to be vetted by the CBK. The vetting is based on a form called CBK/IF1-2 entitled ‘Criteria for determining professional and moral suitability of persons in control of institutions licensed under the Banking Act’ (Central Bank of Kenya, 2006b). The form requires a wide range of data including: - personal information, employment & business record, details of all shareholding, details of all directorships and all borrowing. The form also attempts to judge the integrity of the director and requires information on the criminal records, censure by regulatory authorities, disciplinary proceedings by employers, and record of involvement in bankruptcy or fraud.

This guideline has not been a constraint for FOB and GOB. However, it has had an impact on LPOB and SPOB and has led to significant changes in boards especially amongst SPOB.²⁷⁴

“In the past non-executive directors were chosen in terms of their reputation in the market rather than their actual knowledge of banking. Now, with the emergence of stringent and onerous regulation from CBK, management felt it was necessary to get a more diverse and professional board. Some of the main shareholders are on the board, but we are professional bankers” Bank 7, SPOB

This regulation is likely to have a positive impact on the performance of banks. However, for all SPOB and some LPOB the key constraint in complying with this guideline was the difficulty in getting qualified non-executive directors with the right skill base and the high cost of these non-executive directors:

“There is a big human resource constraint. The regulations are in terms of international best practice but the resources do not exist. We don’t have directors who really understand the regulations and also the skill base is just not there. CBK can specify that we need a risk director but as there are so few risk specialists in the market you get a half-baked person” Bank 4, LPOB, quoted

²⁷⁴ It should be recalled from Chapter 6 that several Asian-African SPOBs were already making changes at board level to change their image as ethnic banks.

“It is difficult to get professional management overnight” Bank 5, LPOB

“It’s not easy to get board members. If CBK moves with an iron fist to ensure compliance amongst small banks, then they may not be able to cope. However, in the long run the costs are justified” Bank 7, SPOB

“For a small bank, having so many board committees can be very expensive. Therefore the main constraint is a human resource problem – attracting the right directors, remunerating them and retaining them” Bank 6, SPOB

Therefore, there remains the risk that there will be symbolic compliance with this regulation.

8.4.6 Disclosure and Transparency

Improvement of information disclosure systems is seen as key to improve corporate governance mechanisms and also to increase market discipline.²⁷⁵ This is linked to OECD Principle 5. In this respect the CBK and CMA guidelines specify several measures.

The CMA corporate governance guidelines are more enlightened, as they require the company to publish the list of the top ten shareholders. The CBK guidelines do not state this as a requirement.²⁷⁶ As discussed in Chapter 6, the perceived reputation of the owners is a key factor determining the ability of banks to mobilize deposits. Therefore it would be very useful if banks also published the ownership structure to allow depositors to know the true ownership rather than making judgments based on perceived reputation of perceived owners.

²⁷⁵ This is also seen a key precondition of effective supervision in the Basel Guidelines. “Effective market discipline depends, in part, on adequate flows of information to market participants, appropriate financial incentives to reward well managed institutions, and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors” (Bank for International Settlements (BIS), 2006).

²⁷⁶ Therefore, Table 30 above had to be constructed from interview data.

One of the key CBK requirements to improve transparency and disclosure is the requirement that banks adopt international accounting standards. It has been shown that adoption of international accounting standards have led to improved disclosure levels and comparability of financial statements (Nganga, Jain, & Artivor, 2003). By extension, it can be argued that this improved the ability of the regulator to perform its supervisory role.

Another key requirement is that all banks have to publish financial statements on a quarterly basis in the national newspapers. The implicit logic of this requirement is that increased transparency and disclosure will increase market discipline (Rochet, 2004). However, as discussed in Chapter 6, Section 6.5, the interviews revealed that banks in all segments agreed that the publication of financial statements has not led to improved understanding by minority shareholders, depositors or the general public. Furthermore, as will be discussed below in the section on minority shareholders, there is evidence for shareholder apathy in Kenya. Therefore this information disclosure system cannot be relied on as a mechanism to increase market discipline.

While it is outside the scope of this chapter and thesis, we would like to highlight a key concern regarding the concept of market discipline. As discussed in Chapter 6, it has become a very popular concept and has been enshrined as the third pillar of Basel II. However its theoretical foundations are still largely unexplored (Llewellyn, 2004; Rochet, 2004; Tsatsaronis, 2004). There are serious questions as to whether market participants – depositors or shareholders - have the ability to monitor banks particularly in developing countries (Caprio & Honohan, 2004; Levy-Yeyati et al., 2004).²⁷⁷ Furthermore, studies that emphasize the role of psychology and herd behaviour in finance raise serious questions as to whether market discipline can be relied on as a regulatory force in finance. Therefore, there needs to be a serious debate on whether this market discipline should form a core basis of financial regulation. We would like to argue that in cases where this principle leads to a reduction in oversight by the regulator, it is likely to have detrimental effects on the overall performance of the financial sector.

²⁷⁷ Referring to the definition of market discipline of Tsatsaronis (2004) quoted earlier in Chapter 6, while shareholders can generally not be considered “outsiders”, we would like to highlight that minority shareholders can be considered “outsiders.”

8.4.7 Insider Lending

As discussed in Chapter 7, the literature shows that insider lending can have both positive and negative effects on bank performance. As discussed in Chapter 1, the interviews revealed very little on insider lending with most banks just saying that they do not practice it. The little evidence we have on the banking sector in Kenya show that insider lending is ruinous to bank performance. For example Trust Bank, which closed in 1998, had total loan portfolio of KShs. 10.1 billion. Of this 5.2 billion (52%) was non-performing. In addition there was another 2.6 billion (25%) of non-performing insider loans (KPMG, 1999). As shown in the table above the CBK guidelines now control insider lending. In particular the guidelines forbid unsecured insider lending. Table 34 below shows that between 2001 – 2005 insider lending has decreased.²⁷⁸

Table 34: Insider Lending in Kenyan Banks 2000 - 2005

Directors Insider Lending / Total Loans						
Segment	2001	2002	2003	2004	2005	Average
FOB	0%	0%	1%	0%	0%	0%
GOB	9%	10%	7%	6%	7%	8%
LPOB	6%	9%	8%	7%	5%	6%
SPOB	10%	11%	8%	5%	4%	8%
Total	6%	8%	6%	5%	4%	6%

One of the possible reasons for the regulation for separation of ownership and management discussed above would be to reduce levels of insider lending. We would like to argue that control of insider lending through strict supervision or regulations that require high levels of capital commitment by shareholders are more likely to be a more effective tool than forced separation of ownership and management. As discussed in Chapter 7, the comparative study of different periods in Mexican banking showed that a system with very high capital ratios is one of the conditions under which insider lending is not pernicious (Maurer & Haber, 2007a, 2007b).

²⁷⁸ There is no consolidated data showing the levels of insider lending in the Kenyan banking sector before 2000.

8.5 Corporate Governance Areas without CBK Guidelines

This section discusses some areas covered by OECD principles for which there are no corresponding CBK guidelines and assesses whether it may be appropriate to have such guidelines in Kenya. These areas are:-

- Overall Corporate Governance Framework
- Rights of stakeholders
- Legal protection for minority shareholders
- Corporate control of banks

8.5.1 Overall Corporate Governance Framework

The OECD principles state “The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities”(Organisation for Economic Co-operation and Development, 2004 pp., 17). With reference to banks there is a general emphasis on the necessity of a sound legal sector and healthy corporate sector (Tobin & Singh, 2008). These institutional ‘prerequisites’ for sound corporate governance are not prevalent in Kenya or most developing countries. Therefore, they should not be viewed as a prerequisite but a key challenge.²⁷⁹ It is difficult for the CBK to legislate for such a broad principle. However, it would be useful if there was recognition, by CBK and CMA, that corporate governance codes alone will not resolve all the problems of banks and corporations. There needs also to be recognition that these codes cannot replace the need for strong prudential regulation by the CBK.

8.5.2 Rights of Shareholders and Stakeholders

As the ownership structure of banks in Kenya is concentrated, the free rider problems of diffused share ownership do not arise and in general the owners are active in controlling management. However, the question still remains whether there are any mechanisms to protect and empower other stakeholders in particular depositors. As we had discussed in Chapter 7 the broadest view of corporate governance, which

²⁷⁹ Refer to the discussion on finance and institutions in Chapter 3 in particularly the criticisms of studies that refer to the *peculiarity* of African institutions.

emphasizes that governance mechanisms should be in the interest of all stakeholders, is extremely relevant. With reference to quoted companies in Kenya it has been argued that the corporate governance codes give very little protection to other stakeholders such as employees or customers (Musikali, 2008). We would like to argue that this is an important missing element in the corporate governance regulation of banks in Kenya. It would be extremely useful if the CBK codes emphasized the fiduciary duty of directors to depositors. Furthermore, instead of relying on publishing financial data in national newspapers in the vain hope that all depositors will read it and monitor banks, the CBK regulation should create a position for a director on the board who is elected by depositors. To date, the author is not aware of any country where such a regulation has been passed but we strongly believe it is an innovative way to increase market discipline.

8.5.3 Legal Protection for Minority Shareholders in Kenya

OECD principle 3 emphasizes equitable treatment of shareholders and in particular, legal protection for minority shareholders. It is argued, “While the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company.... Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder ” (Organization for Economic Co-operation and Development, 2004 pp., 42).

The 2006 CBK Guidelines do not have any regulation relating to the protection of minority shareholders. However, the Companies Act in Kenya (Chapter 486 of the Laws of Kenya) does provide protection of minority shareholders (Kiboi, 2006). The main remedies available to minority shareholders through the Companies Act are in Section 22 which allows minority shareholders to sue directors, under Section 219 which allows minority shareholders to go to court to demand winding up of the company and under Section 211 which allows for other remedies such as injunctions (Kiboi, 2006). However, overall the protection is deficient as firstly, there are no specific provisions for proportional representation of minorities on the boards (Nganga et al., 2003). Secondly, due to the concentration of ownership, even in quoted companies, minority shareholders do not have any other option but to ‘sell or sue’ (Nganga et al., 2003).

Thirdly, even though legal remedies are available for minority shareholders, there is limited awareness about these remedies (Kiboi, 2006). It has been shown that there is still a long way to go before shareholders in Kenya are educated on their rights the current training being provided is mainly targeted at company directors (Musikali, 2008).

We would like to argue that adoption of this OECD guideline by the CBK would not necessarily improve the performance of banks for three main reasons. Firstly, as discussed above there are very few banks in Kenya that have minority shareholders. Secondly, it is important to make a distinction between corporate governance mechanisms that increase the participation of individuals in capital markets and therefore the availability of capital, and mechanisms that reduce agency problems between owners and management and ensure better performance. The NEPAD report bemoans the level of shareholder apathy and shareholder ignorance.²⁸⁰ It argues “Decisions are often made by majority shareholders and the AGM often appears as a forum simply to endorse decisions” (New Partnership for Africa's Development (NEPAD), 2006 pp., 159). Interviews of banks across the segments concurred with this view and revealed that the minority shareholders were generally not concerned about the long-term future of the bank but only in the short-term annual dividend:

“To date we have not had a single motion that has been proposed by the board that has been rejected at the AGM. Shareholders only express anger when we decide to reduce the levels of our dividends.” Bank 1, FOB

“We have about 1100 small shareholders from our merger with XX Bank. During the AGM, they rarely ask any questions from the accounts except ‘why have you not declared a dividend?’ Bank 5, LPOB

“The small shareholders we have from our merger with XX Bank are more concerned about short term dividend policy than long term strategy of the bank.” Bank 7, SPOB

Another interesting point revealed in the interviews was that even in cases where shareholders were also depositors, they played contradicting roles at the same time.

²⁸⁰ It should be noted that even in developed countries there is limited activism by minority shareholders (Glen & Singh, 2005; Singh, 1992).

They demand higher interest rates for their deposits, and, at the same time demand higher dividends. Therefore adoption of this guideline by the CBK will not necessarily improve the stability of the banking sector.

8.5.4 Corporate Control of Banks

The OECD Principle 2 - the rights of shareholders, also highlight the importance of the market for corporate control. “Markets for corporate control should be allowed to function in an efficient and transparent manner. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse” (Organisation for Economic Co-operation and Development, 2004 pp., 19). The market for corporate control or takeovers is a crucial mechanism of disciplining management in the Anglo-American model of governance (La Porta et al., 2000).

In the Kenyan context, even though the CBK guidelines do not have any specific regulations, the legal framework for mergers does exist. However, primarily because of ownership concentration, such a guideline does not seem to be important for any of the four segments. Interviews of banks across the segments indicated that the threat of takeover was not seen as significant even amongst quoted companies:

“No as a bank of our asset size we are underperforming, yet there is not threat of takeover as the ownership structure is tightly knit” Bank 4, LPOB, quoted

“Not relevant at all in Kenya, unless global parent of foreign bank is taken over. Only the state owned or publicly quoted banks have slightly wider shareholding. But even in these, individuals are minority shareholders. If someone tried to buy incremental shares to get a larger stake it would just push up the price. In private banks the shareholding are closely held. Shareholders do not see the value of consolidation partly because it will be difficult to find similar shareholders with similar views.” Bank 3, LPOB

“Not really with most of local small and medium sized banks controlled by family of small group of shareholders, there is not much threat of a take over.” Bank 7, SPOB

“There is no threat of takeovers. The main constraint to merger is a generation issue and a mindset issue. There is also a practical issue. If you are not making a loss why take the risk of merging with another party when there is a risk of losing control” Bank 6, SPOB

We would like to argue that when shareholding is highly concentrated, the threat of takeover cannot be seen as a reliable governance mechanism even when the laws that permit takeovers are clear. Furthermore, when the ownership structure is dominated by family ownerships, mergers and takeovers are also unlikely due to very specific social issues that are very hard to measure – including pride and reputation of the owners and the unwillingness of bank owners to give up control of their banks.

8.6 Concluding Remarks

In Chapter 7 we had shown that theoretically, ownership concentration is a product of social and historical factors and it cannot be stated a priori that either concentrated or diversified ownership is good for performance. Furthermore, we had shown that the separation of ownership and management is more common in the Anglo-American model of diffused ownership but in this corporate governance model raises several agency problems. The key contribution of this chapter is to show that the CBK’s regulation to enforce separation of ownership and management, only affects banks in LPOB and SPOB segment. However due to the high level of ownership concentration this regulation will only be complied to symbolically. We argued that if the aim of this regulation is to reduce insider lending (that has led to bank failures in Kenya in the past amongst owner-managed banks), it will fail in this objective due to symbolic compliance. Therefore, we have argued that strict control of insider lending by the regulator is essential to prevent abuse by directors and rather than this artificial separation of ownership and management.

In Chapter 4 and Chapter 6 we had shown that the key constraint facing GOBs is high level of NPLS due to political interference. As these regulations cannot address this

issue, it is envisaged that the impact of these regulations on NPLS in this segment will be marginal.

Finally we would like to argue that while some of the regulations, in particular, increased board oversight in credit committees are likely to have a positive impact on reducing NPLs in the LPOB and SPOB segment they do not address the key source of segmentation in the market. That is, they cannot increase the level of trust that clients of LPOB and SPOB have in the banks. Therefore their overall impact on the shallowness and fragility of the banking system in Kenya will be at best marginal.

CHAPTER 9 – CONCLUSIONS AND IMPLICATIONS FOR RESEARCH AND POLICY

9.1 Introduction

In this chapter we bring together the analysis in the preceding eight chapters and set out the research and policy implications of this thesis. Section 9.2 discusses the research summary and Section 9.3 summarizes key developments in the banking sector after the fieldwork of this thesis. Section 9.4 outlines the research and policy implications of this thesis.

9.2 Research Summary

9.2.1 Background, History and Segmentation

In Chapter 1, we began by discussing the background and context of this study by presenting data on the shallowness, inefficiency and fragility of the banking sectors in SSA and Kenya. We also introduced the four segments of the Kenyan banking sector that we investigated – foreign owned banks, government owned banks, large private owned banks and small private owned banks. We went on to define the three key relationships in banking - lending, deposit mobilization and corporate governance and the research questions in reference of each of these. The research questions were:-

Lending Relationship:

- How is information collected, what type of information is collected, how is this information processed before a credit allocation decision is made?
- What are the differences in credit allocation processes and monitoring that lead to differential outcomes in terms of good loans or bad loans?
- What are the differences in the credit allocation process between different segments?
- How do social relations affect credit relationships and how are these different amongst different segments?

Deposit Mobilization

- What are the main constraints faced by banks when raising deposits?
- What are the differences in constraints between different segments in the banking sector in Kenya?

Corporate Governance

- What is the structure of ownership and management of the banking sector and how is this different across different segments of the banking sector?
- What is the impact of international codes of corporate governance on the development of regulations on corporate governance in Kenya?
- What is the impact of changes in regulations on corporate governance on the corporate governance practices of banks? Is the impact of these regulations different for different segments?

In Chapter 1, we also discussed methodological basis for our work and emphasized the rationale for using semi-structured interviews during fieldwork. The chapter provided a summary of the data we had collected, the methods of data analysis and problems we had faced in data collection.

We reviewed the main schools of thought on the links between finance and development in Chapter 2. The chapter discussed the debates on whether finance leads to growth, the debates surrounding the design of the financial system and the sources of financial fragility. The chapter showed that there is consensus on how finance can lead to growth and the functions that finance and banks should fulfill including encouraging saving, efficient allocation of resources, agglomerating capital and pooling of risk. However, we also saw that there is very little consensus on the circumstances and institutional characteristics that assist or impede finance to fulfill its functions. This thesis aims to fill this gap by bringing to light the specific institutional characteristics of the banking system in Kenya and explaining how these have driven the shallowness and fragility of the banking sector.

In Chapter 3 we critically engaged with the literature on the financial sector in SSA. We showed that in contrast to the work on financial liberalization and micro finance there is a dearth of studies on the formal financial sector in SSA. More significantly we showed that because of the reliance on mainstream methodology and methods - including large cross country regressions, single country case studies based on the flawed assumption

that high concentration leads to inefficiency and an increasing use of development envelope analysis to calculate efficiency – these studies do little to increase our understanding of the constraints facing banks in SSA.

In Chapter 4, we began by discussing the historical evolution of the banking sector in Kenya up to the period of focus of this thesis (2000-2005). In the chapter we presented data on overall performance of the banking sector including indicators on private credit to GDP, interest rate spreads and bank failures. We showed that despite policy changes from state control to liberalized financial systems the banking sector in Kenya remains shallow, fragile and inefficient. We argued that in line with other studies on finance in SSA, discussed in Chapter 3, studies on the Kenyan banking sector are deficient, in particular due to their reliance on mainstream methods and methodology. In line with mainstream papers we showed the banking sector is highly concentrated but more importantly that the first three banks to be established in Kenya remain dominant even in 2005. We rejected as simplistic the explanation that this high concentration is the cause of inefficiency.

In Chapter 4 we further argued that understanding the nature of segmentation of the banking sector is key to understanding this dominance and more generally the poor performance of the banking sector in Kenya. Using data from banks' financial statements we calculated key performance indicators of the four segments of the banking sector in Kenya – FOB, GOB, LPOB and SPOB. We showed that there was not much difference between the segments in terms of capital adequacy – but in terms of lending and deposit mobilization, there were significant differences between the segments. Foreign and government owned banks enjoy higher margins than large and small private owned banks. While high levels of NPLs in GOB have been well documented in the literature, we showed that SPOB also had high levels of NPLs. We also showed the cost of funds of SPOB is relatively high and that bank failures are concentrated in the SPOB segment. Finally we showed that LPOBs have been relatively successful in increasing their market share. The rest of the thesis attempted to understand the sources of these differences. Why do FOBs and GOBs earn higher margins? And how have LPOBs managed to expand their presence in the market, while SPOB have suffered not only low margins and lack of growth but also high share of NPLs?

9.2.2 Lending and Deposit Mobilization

We found that there was no single theoretical framework that would help us analyze these questions and in Chapter 5 we brought together several theoretical concepts from heterodox schools that are relevant to understanding the lending and the deposit mobilization process and therefore the differences in performance of the different types of banks. We argued that the Post Keynesian concept of knowledge creation has much to contribute to our understanding of the lending process above and beyond the concept of information asymmetry that is usually employed. This is because the concept of knowledge creation emphasizes that both borrower and lender are operating in an uncertain world and with both parties need to employ judgment in the risk assessment process. We also highlighted the Marxist concept that of credit creation is based on trust and credit relations are embedded in social relations. We also discussed the significance of trust between banks and depositors in deposit mobilization. We argued that this depends on the level of economic development and therefore it cannot be simply assumed to exist for developing financial sectors and emphasized that social factors are also important in determining this trust. The theoretical concepts brought together in this chapter emphasize that social and trust factors are more important in driving banking sector behavior than is typically recognized in mainstream literature.

In Chapter 6 we described the constraints to lending that were revealed in the interview data. In particular we showed that the constraints that are well discussed in the literature - that is - the economic and legal environment – affect all segments though they affect the SPOB segment disproportionately. The key aim of Chapter 6 was to highlight the social constraints to lending that are not discussed in the literature. In particular consistent with our argument in Chapter 5, the interviews confirmed the importance of fluid social factors and the intricacies of inadequate information production and monitoring. We showed that each of the segments faces clients of different size and type and this is the basis of segmentation. In particular social factors affect the SPOB segment disproportionately, explaining the low margins and high NPLs of SPOB. Moreover, the data indicated that the impact of social factors is complex and not unidirectional. We also argued that to be able to effectively monitor clients, banks need to develop a mix of arm's length and embedded relationships and that embedded relationships should not be discouraged by regulation. Several LPOB have been able to do this, and this improvement in performance is consistent with their success in increasing their market share. We also showed that due to the importance of social

factors, banks see the soft information they gather as extremely useful in making lending decisions. Therefore we argued that while credit registries are useful, they are not a replacement for the need for banks to really understand their clients. It is also interesting to draw a parallel between this finding and the debates on methodology by heterodox economists that we discussed in Chapter 1. Just as bankers value both hard and soft information, economist should value both quantitative and qualitative data.

In Chapter 6 we further explained that the key constraint faced by SPOB and LPOB in raising deposits is their reputation. We argued that this reputation bias explains why they face a higher cost of funds. This reputation bias is linked to the stage of banking development of the Kenyan banking sector where depositors do not trust all banks equally, that is, there are different radiuses of trust within one banking system. Overall we showed that segmentation is the result of fragmentation rather than specialization as banks in LPOB and SPOB segment are trying to move away from their traditional client base but facing significant constraints in doing so. Segmentation also implies that there are few positive spill-over effects of competition. We also argued that segmentation is both a cause and consequence of shallowness and fragility.

9.2.3 Corporate Governance

In Chapter 7 we provided a synthesis of the corporate governance literature focussing on the two main schools of corporate governance – the Anglo-American and the Eurasian Schools. We showed that ownership patterns and corporate governance are the product of social and historical factors and therefore it is impossible to say *a priori* that certain structures are optimal for firm or bank performance. The chapter also considered studies on the impact of specific board reform on firm performance including - Board Size, Board Independence, CEO / Chairman Duality and Committee Structure of Boards - and again showed that there is very little empirical consensus on what should be considered as ‘best practice’. Despite the inconclusive nature of these studies, we showed that studies on corporate governance in SSA were mainly econometric studies that assume the certain firm characteristics will have impact on firm performance. We argued that there was little attempt to understand how ownership patterns have evolved over time and how even within a country, different firms can have different governance structures. Chapter 7 then discussed the specific problem of insider lending which is a key corporate governance issue of owner-managed banks. Again we showed that it should not be assumed *a priori* that all owner-managed banks

are vehicles for looting and that there is a need to understand the circumstances in which looting is not pernicious.

In Chapter 8 we applied this framework to the Kenyan case by reviewing quantitative and qualitative data on corporate governance of banks in Kenya. Continuing the discussion on the historical development of the banking sector in Chapter 4, this chapter analyzed the data on the ownership structure of the banking sector and showed that most of the banks had a concentrated ownership structure. We then discussed the regulation on corporate governance introduced by the CBK linking these regulations to the OECD and Basel corporate governance principles. We argued that the CBK's regulation to enforce separation of ownership and management was not based on either OECD or Basel principles but implicitly based on the assumption that the Anglo-American model of governance (which separates ownership and control) should be considered as 'best practice'. We argued that due to the highly concentrated ownership structure of the banking sector and the high prevalence of owner-managed banks, within the LPOB and SPOB segments, this regulation would only be complied with symbolically. We argued that strict control of insider lending through supervision and regulations that require higher levels of capital commitment by shareholders are essential to prevent abuse by directors that has led to bank failures in the past.

We argued that some corporate governance regulations in particular the involvement of directors in credit committees is likely to improve the asset quality of banks in particular SPOB. However, as these corporate governance measures do not address the reputation bias against SPOB and cannot change the client base of SPOB they will do little to impact the nature of segmentation of the banking sector. Therefore their impact on overall shallowness and fragility of the sector will be marginal.

9.3 Developments in the Banking Sector Post Fieldwork

9.3.1 Performance of the Banking Sector

The fieldwork for this thesis was carried out in 2006 and the majority of data discussed in Chapter 4 is from 2000 – 2005. Of course the Kenyan banking sector has continued to develop since 2005.

Table 35: Kenyan Banking System Indicators 2004 and 2008

	2004	2008
Liquid Liabilities to GDP	40%	36%
Private Sector Credit to GDP	25%	24%
Net Interest Margin	7%	7%
Interest rate spread	13%	13%
Nonperforming Loans on Total Loans	41%	11%

Source:-

- 1) 2004 data is from Table 1 in Chapter 1. As noted in Chapter 1, the data on NPLs is for 2001.
- 2) 2008 data is from Beck et al.(2010).

The table shows that there has not been any significant financial deepening in the banking sector. Liquid liabilities to GDP ratio in 2008 was 36% and private credit to GDP ratio in 2008 was 24% both of which are lower than the figures for 2004 (Beck et al., 2010).²⁸¹ The figures of interest rate spreads and interest rate margins are almost identical to the figures for 2008.²⁸²

The table shows that the key improvement in the banking sector in Kenya is the quality of credit. The ratio of non-performing loans on total loans in 2008 was 10.9% (Beck et al., 2010) and therefore a dramatic improvement from the figure of 41% in 2001. As discussed in Chapter 6, economic factors play a key role in determining the level of NPLs and Kenya experienced significant GDP growth of approximately 6% from 2004

²⁸¹ As discussed in Chapter 1, these are the two main indicators of financial deepening. See Chapter 1, Table 1

²⁸² Refer to discussions on interest rate spreads in Chapter 4, Section 4.3.3 and Section 4.4.4.

onwards. Furthermore, it shows that the regulatory measures brought in by CBK that we discussed in Chapter 4 and the changes in lending practices brought in by banks themselves that we discussed in Chapter 6 have borne fruit. However, as pointed out by Beck et al.(2010) this ratio is still considerably higher than NPL ratio for other emerging markets for example Brazil and South Africa which had NPL ratios of 4.4% and 1.1% respectively, and therefore there is still room for considerable improvement.

While we do not have the complete disaggregated data for the different segments, Beck et al.(2010) show the cost of funds is still higher for private banks. In 2008 the average deposit rate for private banks was 3.81% but for foreign owned banks was 2.09% and government owned banks was 2.08%.²⁸³

Overall this indicates that while the banking sector in Kenya has become slightly more stable, it still remains fairly shallow, inefficient and highly segmented.

9.3.2 Industry Structure

Some of the key specific developments in the banking sector have been consolidations and takeovers: CFC Bank (LPOB numbered 16) and Stanbic Bank (FOB numbered 4) merged in 2008 to create a large integrated financial services firm including an investment bank (Gikunju, 2008).²⁸⁴ EABS Bank (SPOB numbered 24) was taken over by ECOBank a West African banking group in 2008 (Okoth, 2010). At the end of 2009, the CBK had approved the merger of Southern Credit Banking Corporation (SPOB numbered 30) and Equatorial Commercial Bank (SPOB numbered 34). This merger was to ensure that both banks met the new minimum capital requirement of KShs. 350 million and will operate under the name of Equatorial Commercial Bank (Michira, 2010). CBK had also approved the takeover of City Finance Bank (SPOB numbered 41) by a newly established microfinance bank – Jamii Bora Bank (Anyanzwa, 2010a). We view all these developments as positive. It is hoped the large LPOB – CFC-Stanbic Bank will be able to overcome some of the reputation bias of LPOB and compete with

²⁸³ The authors do not differentiate between large private owned banks and small private owned banks as we have in the thesis.

²⁸⁴ The numbering refers to the bank number in Table 19 in Chapter 4. This numbering is distinct from the labels used in discussing the interview data - Bank 1 to Bank 7. As discussed in Chapter 1 we have not disclosed the names of the banks we have interviewed.

FOB. It is also hoped that larger SPOB will be able to compete more effectively across their segment with some LPOB.

There was only one bank failure between 2006 and 2010: Charterhouse Bank (SPOB numbered 31) was put into statutory management in 2006. In the terminology used in Table 17 in Chapter 4 this bank can be referred to as political with African and Asian-African ownership. This case is particularly intriguing as reports indicate that it was neither illiquid nor insolvent but was put under statutory management due to suspicion of money laundering activities being carried out in the bank (Anyanzwa, 2010b; Mutua, 2010). We have not found any detailed analysis of the reasons for this bank failure published by the CBK or any other economist. Newspaper reports indicate a tussle between the head of the Kenya Anti-Corruption Authority who is arguing that there is firm evidence for fraud carried out in this bank and the Attorney General and Director of Public Prosecution who are arguing that they do not have any evidence to prosecute former directors of the bank (Anyanzwa, 2010b; Mutua, 2010). To date there has been no resolution of this situation and the bank has not been re-opened nor put into liquidation. We would like to argue that this is an extremely negative development. This prolonging of the 'Charterhouse saga' only adds to the lack of trust that depositors have in banks in the SPOB segment in general.

One of the key changes in the banking sector has been the rise of Equity Bank (LPOB numbered 21). In 2005, Equity Bank was the 13th largest bank in Kenya with an asset size of KShs. 11.5 billion and a market share of 1.8%. By 2008 it was the sixth largest bank in Kenya by asset size with assets of over KShs. 78.8 billion and market share of 6.5% (Think Business Ltd, 2009).²⁸⁵ Furthermore, due to a listing on the NSE and an injection of capital by the private equity firm Helios Capital, Equity Bank becomes the third largest bank in Kenya by capitalization with a total capital of KShs. 19.5 billion (Omondi, 2007a). In Chapter 4, we had discussed the dominance of the three largest banks in terms of both asset size and capital base – Barclays Bank, KCB and Standard Chartered Bank – since independence. While Equity Bank has not broken this dominance in terms of total assets, it has broken it in terms of total capital and this is undoubtedly a remarkable achievement. It is all the more remarkable as in 1994 Equity Building Society was declared technically insolvent by the CBK and was only spared

²⁸⁵ Equity Bank had over 2 million customers and 76 branches and 350 ATM machines (G. Wright & Cracknell, 2008).

liquidation due to a shareholder injection of capital (G. Wright & Cracknell, 2008). Equity Bank is a microfinance bank and has received numerous accolades due to its focus on making financial services available to the poor and the ‘unbanked’ (Equity Bank Ltd, 2009). Studies have attributed their success to developing innovative products including ‘no-collateral’ loans, customer focus, investment in human resources and investment in technology (Coates, 2007; G. Wright & Cracknell, 2008). The average loan size of Equity Bank is only KShs. 16,000.²⁸⁶ Therefore, in terms of the broader debate on finance and development, it is highly questionable whether the Equity Bank model can fulfil the long-term needs of investment in the real sector.²⁸⁷

Furthermore, we would like to argue that the rise of Equity Bank only emphasizes our key argument that social factors and trust are extremely important in banking systems in developing countries. We would like to argue that a key reason for the success of Equity Bank is the close association between the Chairman (Mr. Peter K. Munga), key shareholder (Mr. Jimnah Mbaru of Britac Investments), and CEO (Dr. James Mwangi) and the government of President Mwai Kibaki.²⁸⁸ This has meant that while Equity Bank is not a government owned bank, its reputation in terms of stability and trust of depositors, is close to that of a government owned bank. This argument is further

²⁸⁶ This is equivalent to USD 220 at exchange rate for December 2005. This is very small compared to the minimum average of \$137,100 for LPOB and \$68,500 for SPOB as discussed in Chapter 6.

²⁸⁷ All the arguments on the sustainability of microfinance and the questions on whether microfinance reaches the poorest in a country apply in this case as well (Hailu, 2008; Morduch & Armendariz, 2004; Nissanke, 2002).

²⁸⁸ While Kenya registered impressive GDP growth between 2002 and 2007 under the Kibaki administration it has been shown that this was very skewed in terms of geographical and ethnic distribution (Kanyinga, 2007). It has been argued that Kikuyuization of economic resources under Kenyatta and Kalenjinization under Moi was followed by re-Kikuyuization under Kibaki (Lynch, forthcoming). During the 2007 election the two main contenders were Raila Odinga of the Orange Democratic Party and the incumbent President Mwai Kibaki of the Party of National Unity. While the all the early polling results indicated that Raila Odinga would win the election, the results announced by the electoral commission put Mwai Kibaki as the winner and he was sworn in an extremely hurried ceremony (Cheeseman, 2008). The results were highly disputed and were followed by eruption of inter-ethnic violence (Cheeseman, 2008). During this period the camp of Raila Odinga, attempted to mobilize support by boycotting businesses close to Mwai Kibaki. Equity Bank was on the list of business that were boycotted by the supporters of Raila Odinga. After intense negotiations, under the auspices of the African Union, a peace accord was signed on 27th February 2008 and Raila Odinga joined the government of President Kibaki as his Prime Minister.

corroborated by the data that Equity Bank enjoys the highest net interest margin and the lowest cost of deposits of all banks in Kenya (Coates, 2007).

9.3.3 Innovations

Another key development has been the issue of bonds by some FOB and a few LPOB to raise finance directly from the Nairobi Stock Exchange. In 2008, bonds were issued by Barclays Bank (FOB numbered 1), newly merged CFC-Stanbic Bank (now a FOB) and I&M Bank (LPOB numbered 19). Again this is a positive development as it allows banks to raise funds at a cheaper rate than from depositors. However we can raise two points of concern. First, diffused bond holders will not be able to exert any monitoring role of the banks and therefore it should not be assumed that the issuance of bonds will increase market discipline on the banks concerned. Secondly, is to recognize that no SPOB has been able to issue a bond to date and therefore the cost of funds for this segment will continue to be high.

Another key development in the financial services sector in Kenya has been the launch of M-Pesa by mobile phone service provider Safaricom in March 2007. M-Pesa (“M” stands for mobile and “Pesa” is the Swahili word for money) is a small value electronic payment and store of value system that is accessible from ordinary mobile phones (Mas & Radcliffe, 2010a). Its growth has been phenomenal and in 2010 had over 9 million registered users which corresponds to 40% of Kenya’s adult population (Mas & Radcliffe, 2010a). It has become the most popular money transfer mechanism in Kenya and it is estimated that USD 415 million per month is transacted in person-to-person transfers, equal to 17% of Kenya’s 2009 GDP on an annualized basis (FSD Kenya, 2009b; Mas & Radcliffe, 2010b). Studies that estimate access to semiformal finance in Kenya have calculated that it has increased from 7.5% in 2006 to 18% in 2009 (FSD Kenya, 2009a).²⁸⁹ There is also evidence the M-Pesa users use the account as a savings mechanism even though it does not pay interest (FSD Kenya, 2009a).

In May 2010 there was another interesting innovation with the launch of M-Kesho jointly by Safaricom and Equity Bank (M. Kamau, 2010). Kesho is the Swahili word for

²⁸⁹ As discussed in Chapter 1, this thesis does not discuss access to finance or financial inclusion of the poor but instead focuses on formal finance. However we are discussing it here due to the remarkable growth of this service.

tomorrow and the product allows users to move money between their M-PESA ‘mobile wallet’ and an interest-bearing account held with Equity Bank. If successful, this tie-up would dramatically expand poor households’ access to savings accounts. However two key concerns can be raised. First, the CBK needs to formalise the regulation of mobile banking and (branchless banking in general) to contain the inherent risks (Alexandre, Mas, & Radcliffe, 2010). Secondly, while financial access is an extremely valid development goal, it does not resolve the key question we had posed in the beginning of this thesis - which is the need for financial institutions that are able to finance long-term productive investment.

9.4 Issues for Research and Policy Directions

This thesis has shown the value of country specific social factors in understanding the institutional constraints that impact the shallowness and fragility of a banking system.

With reference to banking sectors in SSA and other developing countries this thesis emphasizes that the research agenda should include studies that: -

- Bring together understanding of lending, deposit mobilization, corporate governance and regulation of banking specific countries rather large cross-country studies.
- Put the level of trust between banks and borrowers and banks and depositors at the heart of the research.
- Attempt to understand the social factors that affect lending relationships.
- Attempt to elucidate the social factors that shape the trust depositors have in the banks they save with moving away from studies that simply emphasize the pernicious effects of deposit insurance.
- Aim to understand the history of ownership patterns of banks and the implication of these ownership patterns for the design of corporate governance regulation.
- Use both qualitative and quantitative data.
- Bring together plural and heterodox theoretical concepts.
- Quantitative studies using non-parametric statistical techniques that do not specify dependent and independent variables a priori, including cluster or factor analysis (Finch & McMaster, 2003).

With specific reference to the banking sector in Kenya the following would greatly increase our understanding above and beyond the analysis in this thesis:-

- The need to consolidate our understanding of bank failures by collecting and analyzing data on failed banks from the Deposit Protection Fund Board.²⁹⁰
- Interdisciplinary research to understand why and how informal social monitoring mechanisms between Asian-African banks and their predominantly Asian-African clients developed and then broke down.
- Interviews of depositors of banks of different segments to understand the non-price reasons why they bank with the bank they do and why they trust the bank in which they are depositing their savings.

We now discuss some suggestions on policy based on the findings of this thesis. In the literature the key policy question is generally stated as “how should regulators ensure competitive markets to increase financial intermediation while ensuring stability?” This study while based on the specific context of the banking sector in Kenya, has suggested that the key question for policy makers attempting to improve any SSA banking system should be: - “how can regulators increase trust in the entire system?” As we have shown, trust is based on several social factors and therefore not under the direct control of a regulator – although we do believe there are policies the regulator can put in place to support the establishment of trust relationships. One suggestion is to increase the minimum capital requirement of all banks. We envisage that increasing size is one route through which private banks can overcome the reputation bias against them. Furthermore, as discussed in Chapter 8, better capitalized banks are less prone to insider lending and a reduction in bank failures in the SPOB segment will increase the trust of banks in that segment as a whole. As discussed in Chapter 4 the minimum capital requirements in Kenya are set to rise to KShs. 1 billion (approximately US\$ 12.5 million) by 2012, which - if enforced - should strengthen the sector.

In terms of prudential regulation we would like to argue that besides the Basel Capital Ratios a key statistic that regulators should monitor is the cost of funds for banks. A very high cost of funds is an early indicator that the bank will experience solvency problems in the future and should prompt the regulators to be vigilant of the bank

²⁹⁰ As we had discussed in Chapter 1, we were not able to get data from or speak to anyone at the Deposit Protection Fund Board which is responsible for liquidating failed banks.

concerned and if necessary take corrective steps including asking the management to curtail lending and / or asking the shareholders to increase capital in the bank.

Finally we would like to advocate that other stakeholders including a representative of depositors should be given legislated role on the board of banks. This will increase the direct monitoring of banks and therefore be an additional safeguard against insider lending. It would also help to build and maintain trust relationships between the bank and the depositor base and potentially reduce the cost of funds for the bank. We realise that this mechanism has not been tried and would require significant legal changes. However, we believe that this a better mechanism than the current system of simply publishing financial information of banks in the media and expecting all market participants to act on it.

BIBLIOGRAPHY

- Aaronovitch, S., & Aaronovitch, K. (1947). *Crisis in Kenya*. London: Lawrence & Wishart.
- Abdi, A. (1977). *Commercial Banks and Economic Development : The Experience of Eastern Africa*. New York: Praeger.
- Abu-Bader, S., & Abu-Qarn, A. (2008a). Financial Development and Economic Growth: Empirical Evidence from Six MENA Countries. *Review of Development Economics*, 12(4), 803-817.
- Abu-Bader, S., & Abu-Qarn, A. (2008b). Financial Development and Economic Growth: The Egyptian Experience. *Journal of Policy Modeling*, 30(5), 887-898.
- Adam, C., & O'Connell, S. (1999). Aid, Taxation and Development in Sub-Saharan Africa. *Economics & Politics*, 11(3), 225.
- African Centre for Open Governance (AFRICOG). (2008). *Mission Impossible? Implementing the Ndung'u Report*. Nairobi.
- Agarwala, R. (1983). Price Distortions and Growth in Developing Countries. *Policy Research Working Paper*(575).
- Aikaeli, J. (2006). *Efficiency and the Problem of Excess Liquidity in Commercial Banks in Tanzania*. University of Dar es Salaam, Dar es Salaam.
- Aikaeli, J. (2008). Commercial Banks Efficiency in Tanzania, *CSAE Conference 2008 - Economic Development in Africa*. Oxford.
- Akinboade, O. (2000). The Relationship between Financial Deepening and Economic Growth in Tanzania. *Journal of International Development*, 12, 939-950.
- Al-Zubi, K., Al-Rjoub, S., & Abu-Mhareb, E. (2006). Financial Development and Economic Growth: A New Empirical Evidence From The Mena Countries, 1989-2001. *Applied Econometrics and International Development*, 6(3).
- Alawode, A. (2003). Evaluating Banking Supervision in Africa. *World Bank Africa Region Working Paper Series*, 53.
- Alexandre, C., Mas, I., & Radcliffe, D. (2010). *Regulating New Banking Models that can Bring Financial Services to All*. Seattle, Washington: Bill and Melinda Gates Foundation.
- Allen, F. (2005). Corporate Governance in Emerging Economies. *Oxford Review of Economic Policy*, 21(2), 164-177.
- Allen, F., & Gale, D. (2004). Competition and Financial Stability. *Journal of Money, Credit & Banking*, 36(3), 453-480.
- Anonymous Depositor. (1999, 11th May 2009). The Inside Story of Reliance Bank's Woes. *East African Standard*.
- Anyanzwa, J. (2009, 4th June 2009). CBK Predicts Major Mergers in Banking Sector *East African Standard*.
- Anyanzwa, J. (2010a, 29th March 2010). City Finance Buys Out Jamii Bora. *East African Standard*.
- Anyanzwa, J. (2010b, 8th October 2010). Don't Reopen Bank, says KACC. *East African Standard*.
- Arestis, P., & Eatwell, J. (Eds.). (2008). *Issues in Finance and Industry: Essays in Honour of Ajit Singh*. New York: Palgrave Macmillan.
- Armour, J., Deakin, S., Lele, P., & Siems, M. (2007). How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison, *Finance and Development Conference*. LSE: World Economy and Finance Research Programme.
- Armour, J., Deakin, S., Sarkar, P., Siems, M., & Singh, A. (2008). Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis. *World Economy and Finance Research Programme Working Paper Series*, 0041.
- Armour, J., & Lele, P. (2008). Law, Finance, and Politics: The Case of India. *Centre for Business Research, University Of Cambridge Working Papers*, 361.

- Arun, T., & Turner, J. (2004). Corporate Governance of Banks in Developing Economies: Concepts and Issues. *Corporate Governance*, 12(3), 371-377.
- Aryeetey, E. (2003). Recent Developments in African Financial Markets: Agenda for Further Research *Journal of African Economies*, 12(Supplement 2), ii111-ii152.
- Aryeetey, E., Hettice, H., Nissanke, M., & Steel, W. (1997). Informal Financial Markets under Liberalisation in four African Countries. *World Development*, 25, 817-830.
- Aryeetey, E., Senbet, L., & Udy, C. (1997). Financial Liberalization and Financial Markets in Sub-Saharan Africa. *Journal of African Economies*, 6(Suppl.1), to find.
- Aryeetey, E., & Udy, C. (1997). The Characteristics of Informal Financial Markets in Sub-Saharan Africa. *Journal of African Economies*, 6(Suppl. 1), 161-203.
- Atieno-Odhiambo, E. (2000). Mugo's Prophesy. In B. Ogot & W. Ochieng' (Eds.), *Kenya: The Making of a Nation 1895-1995*. Maseno and Kisumu: Maseno University.
- Aybar, S., & Lapavitsas, C. (2001). Financial System Design and the post-Washington Consensus. In B. Fine, C. Lapavitsas & J. Pincus (Eds.), *Development Policy in the twenty-first century : beyond the post-Washington Consensus* London: Routledge.
- Ayogu, M. (2001). Corporate Governance in Africa: The Record and Policies for Good Corporate Governance. *African Development Review*, 13(2), 308-330.
- Azam, J.-P. (1996). Savings and Interest Rate: The Case of Kenya. *Savings and Development*, XX(1), 33- 43.
- Baker, A. (2008). International Corporate Governance Principles, the Politics of Give and Take and the Virtues of Heterogeneity, *The Political Economy of Corporate Governance*. Queen's University, Belfast.
- Balachandran, P. (1981). An Embattled Community: Asians in East Africa Today. *African Affairs*, 80(320), 317-325.
- Bank for International Settlements (BIS). (2006). *Core Principles for Effective Supervision*. Basel.
- Bank of Zambia. (2004). *Financial Sector Development Programme (2004-2009)*. Lusaka: Bank of Zambia.
- Barth, J., Caprio, G., & Levine, R. (2006). *Rethinking Bank Regulation and Supervision: Till Angels Govern*. Cambridge: Cambridge University Press.
- Baumol, W., Panzar, J., & Willig, R. (1982). *Contestable Markets and the Theory of Industrial Structure*. San Diego, CA: Harcourt Brace Jovanovich.
- Becht, M., Jenkinson, T., & Mayer, C. (2005). Corporate Governance: An Assessment. *Oxf Rev Econ Policy*, 21(2), 155-163.
- Beck, T., Cull, R., Fuchs, M., Getenga, J., Gatere, P., Randa, J., et al. (2010). Banking Sector Stability, Efficiency, and Outreach in Kenya. *World Bank Policy Research Working Paper*, 5442.
- Beck, T., Cull, R., & Jerome, A. (2005). Bank Privatization and Performance: Empirical Evidence from Nigeria. *Journal of Banking & Finance*, 29(8-9), 2355-2379.
- Beck, T., Demirgüç-Kunt, A., & Levine, R. (2000 - revised 2009). A New Database on Financial Development and Structure. *World Bank Economic Review*, 14, 597-605.
- Beck, T., Demirgüç-Kunt, A., & Levine, R. (2003). Law, Endowments and Finance. *Journal of Financial Economics*, 70, 137-181.
- Beck, T., Demirgüç-Kunt, A., & Levine, R. (2006). Bank Concentration, Competition, and Crises: First Results. *Journal of Banking & Finance*, 30, 1581-1603.
- Beck, T., & Fuchs, M. (2004). Structural Issues in the Kenyan Financial System: Improving Competition and Access. *World Bank Policy Research Working Paper*, 3363.
- Beck, T., & Levine, R. (2002). Industry Growth and Capital Allocation: Does having a Market or Bank Based System Matter? *Journal of Financial Economics*(64), 147-180.
- Beck, T., & Levine, R. (2004). Stock markets, Banks, and Growth: Panel Evidence. *Journal of Banking & Finance*, 28, 423-442.

- Bencivenga, V., & Smith, B. (1991). Financial Intermediation and Endogenous Growth. *Review of Economic Studies*(58), 195-209.
- Benston, G., & Smith, C. (1976). A Transaction Cost Approach to the Theory of Financial Intermediation. *Journal of Finance*, 31, 215-231.
- Berger, A., & Humphrey, D. (1997). Efficiency of Financial Institutions: International Survey and Directions for Future Research. *European Journal of Operational Research*, 98 (2), 175-212.
- Berger, A., Hunter, W., & Timme, S. (1993). The Efficiency of Financial Institutions: A Review and Preview of Research Past, Present, and Future. *Journal of Banking and Finance*, 17(2), 221- 249.
- Berle, A., & Means, G. (1932). *The Modern Corporation and Private Property* (1991 ed.). New Brunswick, London: Transaction Publishers.
- Bernanke, B. (1983). Non Monetary Effects of the Financial Crisis in Propagation of the Great Depression. *American Economic Review*, 73(3), 257-276.
- Bernanke, B., & Gertler, M. (1987). Banking in General Equilibrium In W. Barnett & K. Singleton (Eds.), *New Approaches to Monetary Economics*. Cambridge: Cambridge University Press.
- Besanko, D., & Thakor, A. (1992). Banking Deregulation: Allocational Consequences of Relaxing Entry Barriers. *Journal of Banking and Finance*, 16, 909-932.
- Bhaduri, A. (1977). On the Formation of Usurious Interest Rates in Backward Agriculture. *Cambridge Journal of Economics*, 1(4), 341-352.
- Bhaduri, A. (1981). Class Relations and the Pattern of Accumulation in an Agrarian Economy. *Cambridge Journal of Economics*, 5(1), 33-46.
- Bhagat, S., & Black, B. (2002). The Non-Correlation Between Board Independence and Long-Term Firm Performance. *Journal of Corporation Law*, 27(2), 231.
- Bhattacharya, S., & Thakor, A. V. (1993). Contemporary Banking Theory. *Journal of Financial Intermediation*, 3(1), 2-50.
- Black, J. (2002). M0, M1, M2, M3, *A Dictionary of Economics*. Oxford Oxford University Press.
- Blaikie, N. (2000). *Designing Social Research: The Logic of Anticipation*. Cambridge, UK, Malden, MA: Polity Press: Blackwell.
- Blin, M., & Siegmann, K. (2006). The Best of Two Worlds: Between-Method Triangulation in Feminist Economic Research. *SOAS Department of Economics Working Paper Series*, 146.
- Bosire Commission Report. (2004). The Judicial Commission of Inquiry into The Goldenberg Affair. Nairobi: Government Printer.
- Boyd, J., & Prescott, E. (1986). Financial Intermediary-coalitions. *Journal of Economic Theory*, 38(2), 211-232.
- Brown, C. O., & Sedar, D. (2005). The Politics of Bank Failures: Evidence from Emerging Markets. *Quarterly Journal of Economics*, 120(4), 1413.
- Brownbridge, M. (1998a). Financial Distress in Local Banks in Kenya, Nigeria, Uganda and Zambia: Causes and Implications for Regulatory Policy. *Development Policy Review*, 16, 173-188.
- Brownbridge, M. (1998b). Government Policies & the Development of Banking in Kenya. In M. Brownbridge & C. Harvey (Eds.), *Banking in Africa* (pp. 79-103): Africa World Press, James Curry.
- Brownbridge, M., & Harvey, C. (1998). *Banking in Africa*. Africa World Press, Inc.
- Brownbridge, M., & Kirkpatrick, C. (2002). Financial Regulation and Supervision in Developing Countries: An Overview of the Issues. *Development Policy Review*, 20(3), 243-245
- Brownbridge, M., Kirkpatrick, C., & Maimbo, S. (2005). Financial Regulation in Developing Countries: Policy and Recent Experience. In C. Green, C.

- Kirkpatrick & V. Murinde (Eds.), *Finance and Development: Surveys of Theory, Evidence and Policy*. Cheltenham & Northampton, MA: Edward Elgar.
- Bruno, V., & Claessens, S. (2007). Corporate Governance and Regulation: Can There Be Too Much of a Good Thing? *World Bank Policy Research Working Paper*, 4140.
- Buchanan, J., & Deakin, S. (2007). Japan's Paradoxical Response to the New 'Global Standard' in Corporate Governance, *Finance and Development Conference*. LSE, London.
- Buchs, T., & Mathisen, J. (2005). Competition and Efficiency in Banking: Behavioral Evidence from Ghana. *IMF Working Paper*, 05(17).
- Byrd, J. W., & Hickman, K. A. (1992). Do outside directors monitor managers? : Evidence from tender offer bids. *Journal of Financial Economics*, 32(2), 195-221.
- Cable, V. (1969). The Asians of Kenya. *African Affairs*, 68(272), 218-231.
- Calomiris, C., & Kahn, C. (1991). The Role of Demandable Debt in Structuring Optimal Banking Arrangements. *American Economic Review*, 81(3), 497-513.
- Capital Markets Authority. (2002). Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya. Nairobi: Capital Markets Authority.
- Caprio, G. (1994). Banking on Financial Reform? A Case of Sensitive Dependence on Initial Conditions. In G. Caprio, I. Atiyas & P. Honohan (Eds.), *Financial Reform*. Cambridge: Cambridge University Press.
- Caprio, G., Atiyas, I., & Hanson, J. (1994). *Financial Reform*. Cambridge: Cambridge University Press.
- Caprio, G., & Honohan, P. (2004). Can the Unsophisticated Market Provide Discipline? In C. Borio, W. Hunter, G. Kaufman & K. Tsatsaronis (Eds.), *Market Discipline Across Countries and Industries*. Cambridge, Massachusetts: The MIT Press.
- Caprio, G., & Klingebiel, D. (1996). Bank Insolvencies: Bad Luck, Bad Policy or Bad Banking?, *Annual World Bank Conference on Development Economics (ABCDE)*. Washington D.C.: World Bank.
- Caprio, G., Klingebiel, D., Laeven, L., & Noguera, G. (2005). Banking Crisis Database. In P. Honohan & L. Laeven (Eds.), *Systemic Financial Crises : Containment and Resolution*. Cambridge: Cambridge University Press.
- Caprio, G., & Levine, R. (2002). *Corporate Governance in Finance: Concepts and International Observations*. Paper presented at the Building the Pillars of Financial Sector Governance: The Roles of Public and Private Sectors - The 2002 World Bank, IMF and Brookings Institution Conference.
- Central Bank of Kenya. (1972). Money and Banking in Kenya (pp. 34). Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1976). The First Ten Years. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1986). Central Bank of Kenya - It's Evolution, Responsibilities and Organization. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1995). Annual Report and Financial Statements July 1994 - June 1995. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1996). Annual Report and Financial Statements July 1995 - June 1996. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1997). Annual Report and Financial Statements July 1996 - June 1997. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1998). Bank Supervision Annual Report 1998. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (1999). Annual Report and Financial Statements July 1998 - June 1999. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2000a). Bank Supervision Annual Report 2000. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2000b). Prudential Guidelines 2000. Nairobi: Central Bank of Kenya.

- Central Bank of Kenya. (2001). Bank Supervision Annual Report 2001. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2002a). Bank Supervision Annual Report 2002. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2002b). Statistical Bulletin December 2002. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2003). Bank Supervision Annual Report 2003. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2004). Bank Supervision Annual Report 2004. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2005). Bank Supervision Annual Report 2005. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2006a). Bank Supervision Annual Report 2006. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2006b). Prudential Guidelines 2006. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2006c). Statistical Bulletin December 2006. Nairobi: Central Bank of Kenya.
- Central Bank of Kenya. (2008). Bank Supervision Annual Report 2008. Nairobi: Central Bank of Kenya.
- Centre for Corporate Governance Kenya. (2004). *A Study of Corporate Governance Practices in the Commercial Banking Sector in Kenya*. Centre for Corporate Governance Kenya.
- Chang, C., Liao, G., Yu, X., & Ni, Z. (2009). Information from Relationship Lending: Evidence from Loan Defaults in China. *SSRN eLibrary*.
- Chang, H.-J., Park, H.-J., & Yoo, C. G. (1998). Interpreting the Korean Crisis: Financial Liberalisation, Industrial Policy and Corporate Governance. *Cambridge Journal of Economics*, 22, 735-746.
- Cheeseman, N. (2008). The Kenyan Elections of 2007: An Introduction. *Journal of Eastern African Studies*, 2(2), 166 - 184.
- Chege, M. (1997). Paradigms of Doom and the Development Management Crisis in Kenya. *Journal of Development Studies*, 33(4), 552-567.
- Cheng, X., & Degryse, H. (2010). Information Sharing and Credit Rationing: Evidence from the Introduction of a Public Credit Registry. *European Banking Center Discussion Paper*, 075.
- Chick, V. (1992). The Evolution of the Banking System and Theory of Saving, Investment and Interest. In P. Arestis & S. Dow (Eds.), *On Money, Method and Keynes: Selected Essays by Victoria Chick*. London: Macmillan.
- Chick, V. (1997). Some Reflections on Financial Fragility in Banking and Finance. *Journal of Economic Issues*, 31(2), 535-541.
- Chick, V. (2008). Could the Crisis at Northern Rock Have Been Predicted?: An Evolutionary Approach. *Contributions to Political Economy*, 27(1), 115-124.
- Chirwa, E. (2001). Market Structure, Liberalisation and Performance of the Malawian Banking Industry. *AERC Research Paper*(108).
- Ciancanelli, P., & Reyes-Gonzalez, J. A. (2000). *Corporate Governance in Banking: A Conceptual Framework*. Paper presented at the European Financial Management Association Conference, Athens.
- Claessens, S., Djankov, S., & Lang, L. (2000). The Separation of Ownership and Control in East Asian Corporations. *Journal of Financial Economics*, 2000, 81-112.
- Claessens, S., & Laeven, L. (2003). What Drives Bank Competition? Some International Evidence. *Policy Research Working Paper*(3113).
- Coates, B. (2007). Equity Bank. *Stanford Graduate School of Business Case Study*, E260.

- Collier, P. (2004). African Growth: Why a Big Push is Needed - Plenary Session: Commission For Africa *AERC Biannual Research Workshop*. Nairobi, Kenya: AERC.
- Cramer, C. (2002). Homo Economicus Goes to War: Methodological Individualism, Rational Choice and the Political Economy of War. *World Development*, 30(11), 1845-1864.
- Cramer, C. (2003). Does Inequality Cause Conflict? *Journal of International Development*, 15(4), 397-412.
- Cull, R., Fuchs, M., & Lovegrove, A. (2008). *Financial Sector Efficiency and Outreach in Kenya*. Washington D.C.: World Bank.
- Cull, R., Haber, S., & Imai, M. (2006). All Bad, All of the Time? Related Lending and Financial Development. *Wesleyan University, Department of Economics Working Paper*, 015.
- Cull, R., & Martinez Peria, M. S. (2007). Foreign Bank Participation and Crises in Developing Countries. *World Bank Policy Research Working Paper*, 4128.
- Dankova, P. (2006). Contemporary Corporate Governance - Shifting of the Accents. *Economic Annals of University of Belgrade*, 169(April 2006 - June 2006), 43- 61.
- Daumont, R., Gall, F., & Leroux, F. (2004). Banking in Sub-Saharan Africa: What went wrong? *IMF Working Paper*, 04(55).
- Deaton, A., Banerjee, A., Lustig, N., Rogoff, K., & Hsu, E. (2006). *An Evaluation of World Bank Research 1998 - 2005* World Bank.
- Dedman, E. B. (2002). The Cadbury Committee Recommendations on Corporate Governance - A Review of Compliance and Performance Impacts. *International Journal of Management Reviews*, 4, 335-352.
- Deidda, L., & Fattouh, B. (2005). Financial Intermediaries, Markets and Growth: CeFims, School of Oriental and African Studies.
- Demirgüç-Kunt, A., & Detragiache, E. (1997). The Determinants of Banking Crises: Evidence from Developing and Developed Countries. *IMF Working Paper*, 97(106).
- Demirgüç-Kunt, A., & Detragiache, E. (2000). Monitoring Banking Sector Fragility: A Multivariate Logit Approach. *World Bank Economic Review*, 14(2), 287-307.
- Demirguc-Kunt, A., Kane, E., & Laeven, L. (2008). Deposit Insurance Design and Implementation: Policy Lessons from Research and Practice. In A. Demirguc-Kunt, E. Kane & L. Laeven (Eds.), *Deposit Insurance around the World: Issues of Design and Implementation*. Cambridge, Massachusetts; London: The MIT Press.
- Demirgüç-Kunt, A., & Levine, R. (2001). *Financial Structure and Economic Growth: A Cross Country Comparison of Banks, Markets and Development*. Cambridge MA: MIT Press.
- Diamond, D. (1984). Financial Intermediation and Delegated Monitoring. *Review of Economic Studies*, 51, 393-414.
- Diamond, D., & Dybvig, P. (1983). Bank Runs, Deposit Insurance and Liquidity. *Journal of Political Economy*, 91, 401-419.
- dos Santos, P. (2007). *Foreign Capital and Familial Control in Phillipine Banking*. University of London, London.
- Dow, S. (1998). Knowledge, Information and Credit Creation. In R. Rotheim (Ed.), *New Keynesian Economics/Post Keynesian Alternatives* (pp. 214-226). London and New York: Routledge.
- Dow, S. (2002). *Economic Methodology: an Inquiry*. Oxford and New York: Oxford University Press.
- Dow, S., Ghosh, D., & Ruziev, K. (2008). A Stages Approach to Banking Development in Transition Economies. *Journal of Post Keynesian Economics*, 31(1), 3-33.
- Downward, P., Finch, J., & Ramsay, J. (2003). Seeking a Role for Empirical Analysis in Critical Realist Explanation. In P. Downward (Ed.), *Applied Economics and the Critical Realist Critique*. London and New York: Routledge.

- Downward, P., & Mearman, A. (2007). Retrodution as Mixed-Methods Triangulation in Economic Research: Reorienting Economics into Social Science. *Cambridge Journal of Economics*, 31(1), 77-99(23).
- Economist Intelligence Unit. (1986). *Kenya Country Report*. London: The Economist.
- Egesa, K. (2006). Financial Sector Liberalisation and Productivity Change in Uganda's Commercial Banking Sector (Final Report), *AERC Biannual Research Workshop* Nairobi Kenya: AERC.
- Engberg, H. (1965). Commercial Banking in East Africa, 1950-1963. *The Journal of Modern African Studies*, 3(2), 175-200.
- Equity Bank Ltd. (2009). *Annual Report and Accounts*. Nairobi.
- Evans, A., Green, C., & Murinde, V. (2002). Human Capital and Financial Development in Economic Growth: New Evidence Using the Translog Production Function. *International Journal of Finance & Economics*, 7(2), 123-140.
- Ewing, J., & Barclay, E. (2008). Safaricom's Big IPO in Africa. *Businessweek*.
- Fama, E. (1980). Banking in the Theory of Finance. *Journal of Monetary Economics*, 6(1), 39-57.
- Fama, E., & Jensen, M. (1983). Separation of Ownership and Control. *Journal of Law and Economics*, 26, 301-325.
- Fare, R., Grosskopf, S., Lindgren, B., & Roos, P. (1994). Productivity Developments in Swedish Hospitals: A Malmquist Output Index Approach. In A. Charnes, W. Cooper, W. Lewin & L. Seifor (Eds.), *Data Envelopment Analysis : Theory, Methodology, and Application*. Boston: Kluwer Academic Publishers.
- Fargernas, S., Sarkar, P., & Singh, A. (2007). Legal Origin, Shareholder Protection and the Stock Market: New Challenges from Time Series Analysis, *Finance and Development* (Vol. World Economy & Finance Research Programme). LSE.
- Finch, J., & McMaster, R. (2003). A Pragmatic Alliance between Critical Realism and Simple Non-parametric Statistical Techniques. In P. Downward (Ed.), *Applied Economics and the Critical Realist Critique*. London and New York: Routledge.
- Fine, B. (2004). Addressing the Critical and the Real in Critical Realism. In P. Lewis (Ed.), *Transforming Economics: Perspectives on the Critical Realist Project*. London: Routledge.
- Fleetwood, S. (2007). Causal Laws, Functional Relations and Tendencies, *Association of Heterodox Economists (AHE) Postgraduate Workshop*. Bristol.
- Fosu, A., Kimenyi, M., & Ndung'u, N. (2003). Economic Reforms and Restructuring in Sub-Saharan Africa: An Overview. *Journal of African Economies*, 12(Supplement 2), ii1-ii11.
- Freixas, X., & Rochet, J.-C. (1997). *Microeconomics of Banking* (4th ed.). Cambridge and London: The MIT Press.
- Fry, M. (1988). *Money, Interest and Banking in Economic Development*. Baltimore, Maryland: Johns Hopkins University Press.
- FSD Kenya. (2009a). *FinAccess 2009 (Survey of Financial Access in Kenya 2009)*. Nairobi: Financial Sector Deepening Trust.
- FSD Kenya. (2009b). *What Makes a Successful Mobile Money Implementation? M-Pesa in Kenya and Tanzania*. Nairobi: Financial Sector Deepening Trust.
- Fukuyama, F. (1995). *Trust: The Social Virtues and the Creation of Prosperity*. New York: The Free Press Paperbacks.
- Fullbrook, E. (Ed.). (2004). *A Guide to What's Wrong with Economics* (First ed.). London: Anthem Press.
- Gerschenkron, A. (1962). *Economic Backwardness in Historical Perspective*. Cambridge MA: Harvard University Press.
- Gertler, M., & Rose, A. (1994). Finance, Public Policy and Growth. In G. Caprio, I. Atiyas & P. Honohan (Eds.), *Financial Reform*. Cambridge: Cambridge University Press.

- Ghirmay, T. (2004). Financial Development and Economic Growth in Sub-Saharan African Countries: Evidence from Time Series Analysis. *African Development Review*, 16(3), 415-432.
- Giddens, A. (1991). *Modernity and Self-identity: Self and Society in the Late Modern Age*. Cambridge: Polity.
- Gikunju, W. (2007, 17th December 2007). Kimunya hands Equity Nine Year Deal to Keep Real Owners Secret *Business Daily Africa*.
- Gikunju, W. (2008, 16th July 2008). CFC Stanbic Holdings Exempted Over Ownership. *Business Daily Africa*.
- Glen, J., & Singh, A. (2005). Corporate Governance, Competition, and Finance: Re-Thinking Lessons From The Asian Crisis. *Eastern Economic Journal*, 31(2), 219-243.
- Godbillon-Camus, B., & Godlewski, C. J. (2005). Credit Risk Management in Banks: Hard Information, Soft Information and Manipulation. *Large Working Paper Series*.
- Goldsmith, R. (1969). *Financial Structure and Development*. New Haven, Connecticut: Yale University Press.
- Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suarez, L., & Weisbrod, S. (1998). *Financial Regulation: Why, How and Where Now?* London: Routledge and Bank of England.
- Gordon, A. (1998). *The Wages of Affluence: Labour Management in Postwar Japan*. Cambridge M.A.: Harvard University Press.
- Granovetter, M. (1985). Economic Action and Social Structure: The Problem of Embeddedness. *The American Journal of Sociology*, 91(3), 481-510.
- Granovetter, M. (1992). Economic Action and Social Structure : the Problem of Embeddedness. In M. Granovetter & R. Swedberg (Eds.), *The Sociology of Economic Life* (pp. vi, 399 p.). Boulder: Westview Press.
- Greenwald, B., & Stiglitz, J. (1993). Financial Market Imperfections and Business Cycles. *Quarterly Journal of Economics*, 108, 77-114.
- Greenwood, J., & Jovanovic, B. (1990). Financial Development, Growth and the Distribution of Income. *Journal of Political Economy*, 98(5, part 1), 1076-1107.
- Greif, A. (1993). Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition. *American Economic Review*, 83(3), 525.
- Grosh, B. (1991). *Public Enterprises in Kenya : What Works, What Doesn't and Why*. Boulder & London: Lynne Rienner Publishers.
- Gurley, J., & Shaw, E. (1960). *Money in the Theory of Finance*. Washington: Brookings Institution.
- Guttentag, J., & Herring, R. (1987). Emergency Liquidity Assistance for International Banks. In R. Portes & A. Swoboda (Eds.), *Threats to International Financial Stability*. Cambridge: Cambridge University Press.
- Haas, R., & Naaborg, I. (2005). Does Foreign Bank Entry Reduce Small Firms' Access to Credit? Evidence from European Transition Economies. *Netherlands Central Bank, Research Department, DNB Working Papers*, 050.
- Haber, S. (2004). Comment on "How Foreign Participation and Market Concentration Impact Bank Spreads: Evidence from Latin America" by Maria Soledad Martinez Peria and Ashoka Mody. *Journal of Money, Credit & Banking*, 36(3), 539-542.
- Habyarimana, J. (2005). The Benefits of Banking Relationships: Evidence from Uganda's Banking Crisis: Georgetown University.
- Hailu, D. (2008). Equitable Access to Financial Services: Is Microfinancing Sufficient? *International Poverty Centre Policy Research Brief*, 59.
- Harris, L. (1994). Financial Fragility in the Transition to Market Economies. *SOAS Department of Economics Working Paper Series*, 47.

- Harriss, J. (2002). The Case for Cross-Disciplinary Approaches in International Development. *World Development*, 30(3), 487-496.
- Harriss, J. (2003). Widening the Radius of Trust: Ethnographic Explorations of Trust and Indian Business. *Journal of the Royal Anthropological Institute*, 9(4), 755-773.
- Hasan, Z. (2005). Evaluation of Islamic Banking Performance: On the Current Use of Econometric Models. *Munich Personal RePEc Archive* 7272.
- Hazlewood, A. (1979). *The Economy of Kenya - The Kenyatta Era*. Oxford: Oxford University Press.
- Hertig, G. (2005). On-Going Board Reforms: One Size Fits All and Regulatory Capture. *Oxf Rev Econ Policy*, 21(2), 269-282.
- Heugens, P., & Otten, J. (2007). Beyond the Dichotomous Worlds Hypothesis: towards a plurality of corporate governance logics. *Corporate Governance: An International Review*, 15(6), 1288-1300.
- Himbara, D. (1994). *Kenyan Capitalists, the State and Development*. Boulder, CO: Lynne Rienner.
- Hodgson, G. (1988). *Economics and Institutions: A Manifesto for a Modern Institutional Economics*. Cambridge: Polity.
- Hodgson, G. (1998). The Approach of Institutional Economics. *Journal of Economic Literature*, 36(1), 166-192.
- Hodgson, G. (2001). *How Economics Forgot History: The Problem of Historical Specificity in Social Science*. London and New York: Routledge.
- Hoggarth, G., Reidhill, J., & Sinclair, P. J. (2004). *On the Resolution of Banking Crises: Theory and Evidence*. SSRN.
- Holmström, B., & Tirole, J. (1993). Market Liquidity and Performance Monitoring. *The Journal of Political Economy*, 101(4), 678-709.
- Honohan, P. (2000). Banking System Failures in Developing and Transition Countries: Diagnosis and Prediction. *Economic Notes by Banca Monte dei Paschi di Siena SpA*, 2000(1), 83-109.
- Honohan, P., & Beck, T. (2007). *Making Finance Work for Africa* (1st ed.). Washington DC: World Bank.
- Irungu, G. (2007, 2nd October 2007). How Safe is Your Money in the Bank? *Business Daily Africa*.
- Irungu, G. (2010, 3rd June 2010). Why Top Banks are Wary of Small Rivals. *Business Daily Africa*.
- Isaksson, A., & Wihlborg, C. (2002). Financial Constraints on Kenyan Manufacturing. In A. Bigsten & P. Kimuyu (Eds.), *Structure and Performance of Kenyan Manufacturing* (1st ed.). Oxford and New York: Centre for the Study of African Economies, University of Oxford and Palgrave.
- Iskander, M., & Chamlou, N. (2000). *Corporate Governance : A Framework for Implementation*. Washington, D.C.: World Bank.
- Jacobs, P. (2008). A New Generation of Heterodox Development Scholars. *Review of African Political Economy*, 35, 335-340.
- Jappelli, T., & Pagano, M. (1993). Information Sharing in Credit Markets. *The Journal of Finance*, 43(5), 1693-1718.
- Jappelli, T., & Pagano, M. (2002). Information Sharing, Lending and Defaults: Cross-Country Evidence. *The Journal of Banking & Finance*, 26, 2017-2045.
- Jensen, M. (1993). The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems. *The Journal of Finance*, 48(3), 831-880.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the Firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- Jeucken, M. (2001). *Sustainable Finance and Banking : The Financial Sector and the Future of the Planet*. London: Earthscan Publications Ltd.

- John, K., & Senbet, L. (1998). Corporate Governance and Board Effectiveness. *Journal of Banking & Finance*, 22, 371-403.
- Johnson, S. (2003). *"Moving Mountains": An Institutional Analysis of Financial Markets Using Evidence from Kenya*. University of Bath, Bath.
- Johnson, S. (2004a). Gender Norms in Financial Markets: Evidence from Kenya. *World Development*, 32(8), 1355-1374.
- Johnson, S. (2004b). The Impact of Microfinance Institutions in Local Financial Markets: A Case Study from Kenya. *Journal of International Development*, 16, 501-517.
- Johnson, S. (2004c). 'Milking The Elephant' : Financial Markets as Real Markets in Kenya *Development and Change*, 35(2), 247-274.
- Johnson, S. (2005). Fragmentation and Embeddedness: An Alternative Approach to the Analysis of Rural Financial Markets. *Oxford Development Studies*, 33(3&4), 357-375.
- Kagira, B., & Kirkpatrick, C. (2001). Overview of the Kenyan Financial Sector and Recent Policy Reforms, *International Conference on Finance and Development: Evidence and Policy Issues*. Nairobi: KIIPRA.
- Kamau, A., Karingi, S., Ndung'u, N., & Mwaura, S. (2004). Capital Requirements and Bank Behaviour in Kenya: Empirical Evidence. *KIPPRA Discussion Paper*(36).
- Kamau, M. (2010, 18th May 2010). Equity Bank, Safaricom Unveil Product for the Unbanked. *East African Standard*.
- Kanyinga, K. (2000a). *Re-distribution from Above : The Politics of Land Rights and Squatting in Coastal Kenya*. Uppsala: Nordiska Afrikainstitutet.
- Kanyinga, K. (2000b). *Re-distribution from Above: The Politics of Land Rights and Squatting in Coastal Kenya*. Uppsala: Nordiska Afrikainstitutet.
- Kanyinga, K. (2007). Governance Institutions and Inequality in Kenya. In Society for International Development (Ed.), *Readings on Inequality in Kenya: Sectoral Dynamics and Perspectives*. Nairobi: Society for International Development.
- Kariuki, P. (1993). *The Impact of Interest Rate Liberalisation on Financial Savings: The Case of Kenya*. University of Sussex, Brighton.
- Kariuki, P. (1995). The Impact of Interest Rate Liberalisation on Financial Savings: The Case of Kenya. *African Review of Money, Finance and Banking*, 95, 5-20.
- Keeley, M. (1990). Deposit Insurance, Risk and Market Power in Banking. *American Economic Review*, 80(5), 1183-1200.
- Kenny, C., & Williams, D. (2001). What Do We Know About Economic Growth? Or, Why Don't We Know Very Much? *World Development*, 29(1), 1-22.
- Keynes. (1921 [1973]). *A Treatise on Probability reprinted as The Collected Works of J.M. Keynes vol. VIII*. London: Macmillan.
- Khatkhate, D. (1988). Assessing the Impact of Interest Rates in Less Developed Countries. *World Development*, 16(5), 577-588.
- Kiboi, E. (2006). *Protection of the Rights and Interests of Minority Shareholders*. Nairobi: Ameli Inyangu and Partners Advocates.
- Klausner, M., & White, L. (1993). Bank Regulatory Reform and Bank Structure. In M. Klausner & L. White (Eds.), *Structural Change in Banking*. New York: New York University.
- Klopp, J. (2000). Pilfering the Pubic: The Problem of Land Grabbing in Contemporary Kenya. *Africa Today*, 47(1), 6-26.
- KPMG. (1999). *Trust Bank Limited: Scheme of Arrangement*. Nairobi: KPMG.
- Kroll Associates. (2007). *The Looting of Kenya under President Moi - 'The Kroll Report'*
- Kumba, S. (2008, 19th September 2008). Time Running Out for Millions Lost in Euro Bank Scandal *Daily Nation*.
- Kyendo, M. (1999). CBK Seeks More Powers to Police Banks. *Daily Nation*.
- Kyereboah-Coleman, A. (2007). Corporate Governance and Shareholder Value Maximization: An African Perspective. *African Development Review*, 19(2), 350-367.

- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (1998). Law and Finance. *Journal of Political Economy*, 106, 1113-1155.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2000). Investor Protection and Corporate Governance. *Journal of Financial Economics*, 58(1-2), 3-27.
- La Porta, R., Lopez-de-Silanes, F., & Zamarripa, G. (2003). Related Lending. *The Quarterly Journal of Economics*, 118(1).
- Lamoreaux, N. (1994). *Insider Lending : Banks, Personal Connections, and Economic Development in Industrial New England* Cambridge: Cambridge University Press.
- Lapavistas, C. (2003). *Social Foundations of Markets, Money, and Credit*. London: Routledge.
- Lapavistas, C. (2007). Information and Trust as Social Aspects of Credit. *Economy and Society*, 36(3), 416-436.
- Law, J., & Smullen, J. (Eds.). (2002). *A Dictionary of Economics*: Oxford University Press.
- Lawson, T. (1997). *Economics and Reality*. London: Routledge.
- Lawson, T. (2003). *Reorienting Economics*. London: Routledge.
- Lee, F. (2002). Theory Creation and the Methodological Foundation of Post Keynesian Economics. *Cambridge Journal of Economics*, 26, 789-804.
- Lee, F. (2007). The Research Assessment Exercise, the State and the Dominance of Mainstream Economics in British Universities. *Cambridge Journal of Economics*, 31, 309-325.
- Leland, H., & Pyle, D. (1977). Information Assymetries, Financial Structure and Financial Intermediation. *The Journal of Finance*, 32, 371-387.
- Levine, R. (1997). Financial Development and Economic Growth: Views and Agenda. *Journal of Economic Literature*, 35 (June), 688-726.
- Levine, R. (2002). Bank-Based or Market-Based Financial Systems: Which is Better? *Journal of Financial Intermediation*, 11(4), 398-428.
- Levine, R. (2004). The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence. *Policy Research Working Paper*, 3404.
- Levy-Yeyati, E., Martinez Peria, M. S., & Schmukler, S. (2004). Market Discipline in Emerging Economies: Beyond Bank Fundamentals. In C. Borio, W. Hunter, G. Kaufman & K. Tsatsaronis (Eds.), *Market Discipline Across Countries and Industries*. Cambridge, Massachusetts: The MIT Press.
- Leys, C. (1975). *Underdevelopment in Kenya: The Political Economy of Neo-Colonialism*. London: Heinemann, Educational Books.
- Lin, J. (2009). Walk, Don't Run. *The Economist*, 11th July 2009.
- Lindgren, C.-J. (2007). Actual and Near-Miss Cross Border Crises. In D. Evanoff, G. Kaufman & J. R. LaBrosse (Eds.), *International Financial Instability: Global Banking and National Regulation* New Jersey: World Scientific.
- Lipton, M., & Lorsch, J. (1992). A Modest Proposal for Improved Corporate Governance. *Business Lawyer*, 48, 59-77.
- Llewellyn, D. (2005). Banking Regulation after Recent Financial Crises: Lessons For Developing and Developed Countries. In C. Green, C. Kirkpatrick & V. Murinde (Eds.), *Finance and Development : Surveys of Theory, Evidence and Policy*. Cheltenham & Northampton, MA: Edward Elgar.
- Llewellyn, D. (2004). Inside the "Black Box" of Market Discipline. In C. Borio, W. Hunter, G. Kaufman & K. Tsatsaronis (Eds.), *Market Discipline Across Countries and Industries*. Cambridge, Massachusetts: The MIT Press.
- Love, I., & Mylenko, N. (2003). Credit Reporting and Financing Constraints. *World Bank Working Paper*, 3142.
- Lucas, R. (1988). On the Mechanics of Economic Development. *Journal of Monetary Economics*, 22(1), 3-42.
- Lumiti, C. (2008, 30th August 2008). IFC Lauds Kenya's Credit Bureau Regulations *East African Business Week*.

- Macey, J., & O'Hara, M. (2001). The Corporate Governance of Banks. *Federal Reserve Bank of New York Economic Policy Review*.
- Maganda, W. (2009). The Indian Diasporic Politics in Post Colonial East Africa, *Contemporary India-East Africa Relations: Shifting Terrains of Engagement*. The British Institute in Eastern Africa, Nairobi.
- Maimbo, S. (2002). The Diagnosis and Prediction of Bank Failures in Zambia 1990-98. *Development Policy Review*, 20(3), 261-278.
- Mamdani, M. (1999). There Can be no African Renaissance without and African-focused Intelligentsia. In M. Makgoba (Ed.), *African Renaissance: The New Struggle*. Cape Town: Mafube Publishing.
- Mangat, J. (1968). *A History of the Asians in Kenya. c.1886 - 1945*. Oxford: Clarendon Press.
- Martinez Peria, M. S., & Mody, A. (2004). How Foreign Participation and Market Concentration Impact Bank Spreads: Evidence from Latin America. *Journal of Money, Credit & Banking*, 36(3), 511-537.
- Mas, I., & Radcliffe, D. (2010a). *Mobile Payments go Viral: M-PESA in Kenya*. Seattle, Washington: Bill and Melinda Gates Foundation.
- Mas, I., & Radcliffe, D. (2010b). *Scaling Mobile Money*. Seattle, Washington: Bill and Melinda Gates Foundation.
- Maurer, N., & Haber, S. (2007a). Related Lending and Economic Performance: Evidence from Mexico. *The Journal of Economic History*, 67(3).
- Maurer, N., & Haber, S. (2007b). Related Lending: Manifest Looting or Good Governance? Lessons from the Economic History of Mexico. In S. Edwards, G. Esquivel & G. Mafarquez (Eds.), *The Decline of Latin American Economies: Growth, Institutions, and Crises* (pp. 213-242). Cambridge, Massachusetts: National Bureau of Economic Research.
- Mavrotas, G. (2005). Savings and Financial Sector Development: Assessing the Evidence. In C. Green, C. Kirkpatrick & V. Murinde (Eds.), *Finance and Development: Surveys of Theory, Evidence and Policy*. Cheltenham. Northampton: Edward Elgar.
- Maxon, R. (1992). The Colonial Financial System. In W. Ochieng & R. Maxon (Eds.), *An Economic History of Kenya*. Nairobi: East African Educational Publishers.
- Maxon, R., & Ndege, P. (1995). The Economics of Structural Adjustment. In B. Ogot & W. Ochieng' (Eds.), *Decolonization and Independence in Kenya, 1940-93*.
- Mayes, D. (2004). An Approach to Bank Insolvency in Transition and Emerging Economies. *Bank of Finland Discussion Papers*, 4.
- Mazuri, A. (1976). The De-Indianization of Uganda: Who is a Citizen? In D. Smock & K. Bentsi-Enchill (Eds.), *The Search for National Integration in Africa* (pp. 77-90). New York: The Free Press.
- McKinnon, R. (1973). *Money and Capital in Economic Development*. Washington DC: Brookings Institute.
- McKinnon, R. (1988). Financial Liberalisation in Retrospect: Interest Rate Policies in LDCs. In G. Ranis & T. Shultz (Eds.), *The State in Development Economics: Progress and Perspectives*. New York: Basil Blackwell.
- Mearman, A. (2003). 'Open Systems' and Economic Methodology, *INEM Conference*. Leeds.
- Michira, M. (2010, 2nd June 2010). Equatorial and Southern Credit Merger Gets Nod. *Business Daily Africa*.
- Miles, M., & Huberman, M. (1994). *Qualitative Data Analysis*. Newbury Park, California: Sage.
- Milonakis, D., & Fine, B. (2008). *From Political Economy to Economics : Method, the Social and the Historical in the Evolution of Economic Theory*. New York: Routledge.
- Mines, M. (1994). *Public Faces, Private Voices: Community and Individuality in South India*. Cambridge: Cambridge University Press.

- Minsky, H. (1982). *Can "It" Happen Again? : Essays on Instability and Finance*. New York: Armonk, N.Y. : M.E. Sharpe.
- Mkandawire, T. (1999). The Political Economy of Financial Reform in Africa. *Journal of International Development*, 11, 321-342.
- Mkandawire, T., & Soludo, C. (1999). *Our Continent, Our Future: African Perspectives on Structural Adjustment*. Dakar: CODESRIA.
- Monks, R., & Nell, M. (2004). *Corporate Governance* (3rd ed.). Malden: Blackwell Pub.
- Morck, R. (2007). Behavioral Finance in Corporate Governance - Independent Directors and Non-Executive Chairs, *University of Alberta Working Paper Series: SSRN*.
- Morduch, J., & Armendariz, B. (2004). Microfinance: Where Do We Stand? In C. Goodhart (Ed.), *Financial Development and Economic Growth: Explaining the Links*. Basingstoke, Hampshire, UK: Palgrave Macmillan.
- Moss, T. (2003). *Adventure Capitalism - Globalization and the Political Economy of Stock Markets in Africa* (1st ed.). New York: Palgrave Macmillan.
- Mpuga, P. (2002). The 1998-99 Banking Crisis in Uganda: What was the Role of the New Capital Requirement? *Journal of Financial Regulation and Compliance*, 10(3), 224-242.
- Mugume, A. (2006). Market Structure and Performance in Uganda's Banking Industry, *AERC Biannual Workshop 2006*. Nairobi, Kenya: AERC.
- Muiruri, S. (2003, 27th February 2003). Euro Bank Officials Quizzed. *Daily Nation*.
- Musikali, L. (2008). The Law Affecting Corporate Governance in Kenya: A Need for Review *International Company and Commercial Law Review*, 19(7), 213-227.
- Musonda, A. (2008). Deregulation, Market Power and Competition: An Empirical Investigation of the Zambian Banking Industry, *CSAE Conference 2008 - Economic Development in Africa*. Oxford.
- Mutua, M. (2010, 1st November 2010). No Evidence Against Charterhouse. *East African Standard*.
- Mwega, F., Ngola, S., & Mwangi, N. (1990). Real Interest Rates and the Mobilization of Private Savings in Africa. *AERC Research Paper*, 2.
- Nasibi, R. (1992). Financial Institutions and Monetary Policy in Post-Independence Kenya. In W. Ochieng & R. Maxon (Eds.), *An Economic History of Kenya*. Nairobi: East African Educational Publishers.
- Ncube, M. (2007). Financial Services and Economic Development in Africa. *Journal of African Economies*, 16(Suppl. 1), 13-57.
- Ndebbio, J. (2004). Financial Deepening, Economic Growth and Development: Evidence from Selected Sub-Saharan African Countries. *AERC Research Paper*, 142.
- Ndege, P. (2000). Modernisation of the Economy 1964-1970. In B. Ogot & W. Ochieng' (Eds.), *Kenya: The Making of a Nation 1895-1995*. Maseno and Kisumu: Maseno University.
- Ndii, D. (1994). *An Asymmetric Information Analysis of Financial Sector Policy in Kenya*. University of Oxford, St. Anthony's College, Oxford.
- Ndii, D. (1998, 28th September 1998). Weak Regulation Could Undermine Kenyan Banking. *The East African*.
- Ndung'u, N., & Ngugi, R. (1999). Adjustment and Liberalization in Kenya: The Financial and Foreign Exchange Markets. *Journal of International Development*, 11, 465-491.
- Ndung'u, N., & Ngugi, R. (2000). *Banking Sector Interest Rate Spread in Kenya* (Vol. 5). Nairobi: Kenya Institute for Public Policy Research and Analysis.
- Ndungu Land Commission Report. (2004). Report of the Commission of Inquiry into the Illegal/Irregular Allocation of Public Land. Nairobi: Government Printer.

- Ndungu, P. (2006). 'Tackling Land Related Corruption In Kenya: World Bank Site Resources.
- Neve, G. D. (2005). 'Trust, Trade and Knowledge: Exploring Family Business Histories from South India *Anthropology Seminar 2005* London: SOAS, University of London.
- New Partnership for Africa's Development (NEPAD). (2006). *African Peer Review Mechanism: Country Review Report of the Republic of Kenya*. Johannesburg: NEPAD.
- Nganga, S., Jain, V., & Artivor, M. (2003). *Corporate Governance in Africa : A Survey of Publicly Listed Companies*. London: London Business School.
- Ngugi, R. (2000). Financial Sector Reform Process in Kenya: 1989-96. *African Development Review*, 12(1), 52-77.
- Ngugi, R. (2001). An Empirical Analysis of Interest Rate Spread in Kenya. *AERC Research Paper*, 106.
- Ngugi, R. (2004). Determinants of Interest Rate Spread in Kenya. *KIPPRA Discussion Paper Series*, 41.
- Ngugi, R., & Kabubo, J. (1998). Financial Sector Reforms and Interest Rate Liberalization: The Kenya Experience. *AERC Research Paper*, 72.
- Nissanke, M. (2001). Financing Enterprise Development in sub-Saharan Africa. *Cambridge Journal of Economics*, 25, 343-367.
- Nissanke, M. (2002). Donors' Support for Microcredit as Social Enterprise: A Critical Reappraisal. *UNU-WIDER Research Paper*, 127.
- Nissanke, M., & Aryeetey, E. (1998). *Financial Integration and Development: Liberalisation and Reform in sub-Saharan Africa*. Routledge.
- Nissanke, M., & Aryeetey, E. (2006). Institutional Analysis of Financial Market Fragmentation in Sub-Saharan Africa: A Risk-Cost Configuration Approach. *UNU-WIDER Research Paper*, 87.
- Nissanke, M., & Stein, H. (2003). Financial Globalization and Economic Development: Toward an Institutional Foundation. *Eastern Economic Journal*, 29(2), 287-308.
- Njenga, G., Ngugi, R., & Mwaura, M. (2006). Development Finance Institutions in Kenya: Issues and Policy Options. *KIPPRA Working Paper*, 14/2006.
- North, D. C. (1989). Institutions and Economic Growth: An Historical Introduction. *World Development*, 17(9), 1319-1332.
- Nowrojee, P. (2001). Asian African Business - The National Perspective: Asian African Heritage Trust.
- Nzioka, P. (1999, 8th June 1999). CBK Lifts Halt on Licensing Banks. *The People*.
- Odhiambo, N. (2008). Financial Depth, Savings and Economic Growth in Kenya: A Dynamic Causal Linkage. *Economic Modelling*, 25, 704-713.
- Odhiambo, N. (2009). Interest Rate Reforms, Financial Deepening and Economic Growth in Kenya: An Empirical Investigation *The Journal of Developing Areas*, 43(1).
- Okoth, J. (2010, 10th February 2010). Ecobank's Lot to Improve as Gamble Pays Off. *East African Standard*.
- Olsen, W. (2006). Pluralism, Poverty and Sharecropping: Cultivating Open-Mindedness in Development Studies. *Journal of Development Studies*, 42(7), 1130-1157.
- Olsen, W. (2008). Realist Ontology and Epistemology for Rural Research. *Brooks Poverty Institute Working Paper*, 53.
- Olsen, W., & Morgan, J. (2004). A Critical Epistemology of Analytical Statistics: Addressing the Sceptical Realist, *British Sociological Association*. York.
- Olukoshi, A. (2006). African scholars and African Studies. *Development in Practice*, 16(6), 533-544.
- Omondi, M. (2007a, 15th November 2007). Equity Races Ahead of Rivals with Sh11bn Capital Injection. *Business Daily Africa*.

- Omondi, M. (2007b, 6th June 2007). NBK Earnings Forecast to Soar as State Settles Debts *Business Daily Africa*.
- Onyonka, Z. (1968). *Agricultural Development Banking: A Case Study of Kenya*. Syracuse University, New York.
- Organisation for Economic Co-operation and Development. (2004). *The OECD Principles of Corporate Governance*. Paris: OECD.
- Organization for Economic Co-operation and Development. (2004). *The OECD Principles of Corporate Governance*. Paris: OECD.
- Oshikoya, T. (1992). Interest Rate Liberalization, Savings, Investment and Growth: The Case of Kenya. *Savings and Development*, XVI, 305-320.
- Pagano, M. (1993). Financial Markets and Growth an Overview. *European Economic Review*, 37(April), 613-622.
- Pandurang, M. (2009). Scrutinising the Past: A Review of Socio-Literary Narratives of the East African Asian Diasporic Experience. *South Asian Diaspora*, 1(1), 47-61.
- Panzar, J., & Rosse, J. (1987). Testing For 'Monopoly' Equilibrium. *Journal of Industrial Economics*, 35(4), 443.
- Patel, Z. (2009). Race Relations Between Kenya's Africans and South Asians *Contemporary India-East Africa Relations: Shifting Terrains of Engagement*. The British Institute in Eastern Africa, Nairobi.
- Patrick, H. (1966). Financial Development and Economic Growth in Underdeveloped Countries. *Economic Development and Cultural Change*, 14(2), 174-189.
- Popiel, P. (1994). Financial Systems in Sub-Saharan Africa. *World Bank Discussion Papers Africa Technical Department Series*, 260.
- Porter, M. (1979). How Competitive Forces Shape Strategy. *Harvard Business Review*, 57(2), 137-145.
- Raheja, C. G. (2005). Determinants of Board Size and Composition: A Theory of Corporate Boards. *Journal of Financial & Quantitative Analysis*, 40(2), 283-306.
- Ramakrishnan, R., & Thakor, A. (1984). Information Reliability and a Theory of Financial Intermediation. *Review of Economic Studies*, 51, 415-432.
- Reinhart, C., & Tokatlidis, I. (2003). Financial Liberalisation: The African Experience. *Journal of African Economies*, 12 (Supplement 1), 53-88.
- Republic of Kenya. (1968). Development Plan 1969-1974. Nairobi: Government Printer.
- Republic of Kenya. (2003). Economic Recovery Strategy for Wealth and Employment Creation. In M. o. P. a. N. Development (Ed.). Nairobi: Government Printer.
- Robinson, J. (1952). *The Rate of Interest and Other Essays*. London: Macmillan.
- Rochet, J.-C. (2004). Market Discipline in Banking: Where Do We Stand? In C. Borio, W. Hunter, G. Kaufman & K. Tsatsaronis (Eds.), *Market Discipline Across Countries and Industries*. Cambridge, Massachusetts: The MIT Press.
- Rochet, J.-C. (2008). *Why Are There So Many Banking Crises: The Politics and Policy of Bank Regulation*. Princeton and Oxford: Princeton University Press.
- Romer, P. M. (1986). Increasing Returns and Long-Run Growth. *Journal of Political Economy*, 94(5), 1002-1037.
- Ruziev, K. (2006). *Money and Banks in Transition Economies: The Case of Uzbekistan*. University of Stirling, Stirling, Scotland.
- Sanda, A., Mikailu, A., & Garba, T. (2005). Corporate Governance Mechanisms and Firm Financial Performance in Nigeria. *AERC Research Paper*, 149.
- Sanda, A., Mikailu, A., & Garba, T. (2007). Board Independence and Firm Financial Performance: Evidence from Nigeria, *AERC Biannual Research Workshop, December 2007*. Dar-es-Salaam, Tanzania: AERC.
- Schumpeter, J. (1911). *The Theory of Economic Development*. Cambridge MA: Harvard University Press.
- Seidenberg, D. (1996). *Mercantile Adventurers : the World of East African Asians 1750-1985*. New Delhi: New Age International.

- Serieux, J. (2008). Financial Liberalization and Domestic Resource Mobilization in Africa: An Assessment. *International Poverty Centre Working Paper*, 45.
- Shackle, G. (1972). *Epistemics and Economics*. Cambridge: Cambridge University Press.
- Shaw, E. (1973). *Financial Deepening in Economic Development*. New York: Oxford University Press.
- Shipton, P. (1992). Debts and Trespasses: Land, Mortgages, and The Ancestors In Western Kenya. *Africa*, 62(3), 357-388.
- Shleifer, A., & Vishny, R. (1997). A Survey of Corporate Governance. *Journal of Finance*, 52, 737-783.
- Singh, A. (1992). The Stock Market and Economic Development: Should Developing Countries Encourage Stock Markets? *UNCTAD Discussion Paper* (49).
- Singh, A. (2005). Corporate Governance, Competition and Finance: Re-thinking the Lessons from the Asian Crisis. *Eastern Economic Journal*, 31(2), 219 - 243.
- Singh, A. (2009). Better to be Rough and Relevant than to be Precise and Irrelevant: Reddaway's Legacy to Economics. *Cambridge Journal of Economics*, 33, 363-379.
- Singh, A., & Weisse, B. (1999). The Asian Model : A Crisis Foretold? *International Social Science Journal*, 51(2), 203-215.
- Singh, A., & Zammit, A. (2006). Corporate Governance, Crony Capitalism and Economic Crises: should the US business model replace the Asian way of doing business? *Corporate Governance: An International Review*, 14(4), 220-233.
- Smullen, J., & Hand, N. (2005). *A Dictionary of Finance and Banking*. (Oxford Reference Online ed.). Oxford: Oxford University Press.
- Söderbom, M. (2001). *Constraints and Opportunities in Kenyan Manufacturing: Report on the Kenyan Manufacturing Enterprise Survey 2000*: UNIDO and CSAE.
- Southall, R. (2005). The Ndungu Report: Land & Graft in Kenya. *Review of African Political Economy*, 32(103), 142-151.
- Soyibo, A. (1997). Banking Sector Reforms in Africa: Effects on Savings, Investment and Development. *African Development Review*, 9(1), 52-76.
- Soyibo, A. (1997). Financial Liberalisation and Bank Restructuring in Sub-Saharan Africa: Some Lessons for Sequencing and Policy Design. *Journal of African Economics*, 6(1), 100-150.
- Soyibo, A., & Adekanye, F. (1992). The Nigerian Banking System in the Context of Policies of Financial Regulation and Deregulation. *AERC Research Paper*, 17.
- Soyibo, A., Alashi, S., & Ahmad, M. (2004). A Positive and Normative Analysis of Bank Supervision in Nigeria. *AERC Research Paper*, 145.
- Stiglitz, J. (1985). Credit Markets and the Control of Capital. *Journal of Money, Credit and Banking*, 17(2), 133-152.
- Stiglitz, J. (1993). The Role of the State in Financial Markets. In World Bank (Ed.), *Proceeding of the World Bank Conference on Development Economics* (pp. 41-46). Washington, D.C: World Bank.
- Stiglitz, J., Helmann, T., & Murdoch, K. (2000). Liberalisation, Moral Hazard in Banking and Prudential Regulation: Are Capital Requirements Enough? *American Economic Review*, 90(1), 147-165.
- Stiglitz, J., & Weiss, A. (1981). Credit Rationing in Markets with Imperfect Information. *American Economic Review*, 393-410.
- Suehiro, A. (2001). Family Business Gone Wrong? Ownership Patterns and Corporate Performance in Thailand. *ADB Institute Working Paper*, 19.
- Sun, L. (Ed.). (2003). *Ownership and Governance of Enterprises: Recent Innovative Developments*. London: Palgrave Macmillan Press.
- The Asian-African Heritage Trust. (2000). *The Asian-African Heritage Exhibition: Identity and History*. Nairobi: National Museums of Kenya and The Asian-African Heritage Trust.

- Think Business Ltd. (2009). Banking Survey 2009. *Think Business (formerly Market Intelligence), Annual Special Edition*.
- Throup, D. (1987). The Construction and Destruction of the Kenyan State. In M. Schatzberg (Ed.), *The Political Economy of Kenya*. New York: Praeger.
- Tobin, D. (2008). Creating Order in the Absence of Formal Regulations and Law: a Historical Perspective on Corporate Governance and Its Lessons for Developing Countries, *The Political Economy of Corporate Governance*. Queen's University Belfast.
- Tobin, D., & Singh, S. (2008). International Best Practices, Domestic Constraints and International Listing: Evidence From China's State Banking Sector. *Journal of Chinese Economic and Business Studies*, 6(4), 341-361.
- Trust Bank Ltd. (1997). *Annual Report and Accounts*. Nairobi.
- Tsatsaronis, K. (2004). Comments on the Theory of Market Discipline. In C. Borio, W. Hunter, G. Kaufman & K. Tsatsaronis (Eds.), *Market Discipline Across Countries and Industries*. Cambridge, Massachusetts: The MIT Press.
- Upadhyaya, R. (2008). "The Stock Market is Not a Fish Market": The Stock Market and the Distribution of Economic Opportunities in Kenya, *African Studies Seminar: Neglected Themes of the Kenya Crisis*. St Antony's College, Oxford.
- Uzzi, B. (1999). Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing. *American Sociological Review*, 64, 481-505.
- Vandenberg, P. (2003). Ethnic-sectoral Cleavages and Economic Development: Reflections on the Second Kenya Debate *The Journal of Modern African Studies*, 41(3).
- Vandenberg, P. (2006). *The African-Asian Divide : Analyzing Institutions and Accumulation in Kenya*. New York ; London: Routledge.
- Vittas, D. (1991). Measuring Commercial Bank Efficiency. *World Bank Policy Research Working Paper*, 806.
- Vives, X. (2001). Competition in the Changing World of Banking. *Oxford Review of Economic Policy*, 17(4).
- Wade, R. (2007). A New Global Financial Architecture. *New Left Review*, 46, 113-129.
- Wai, U. (1992). What Have We Learned About Informal Finance in Three Decades'. In D. Adams & D. Fitchett (Eds.), *Informal Finance in Low Income Countries* (pp. 337-348). Boulder, CO: Westview Press.
- Warutere, P. (2005). The Goldenberg Conspiracy: The Game of Paper Gold, Money and Power. *The Institute for Security Studies Occasional Paper*, 177.
- Weisbach, M. S. (1988). Outside directors and CEO turnover. *Journal of Financial Economics*, 20, 431-460.
- Wooldridge, J. (2006). *Introductory Econometrics : A Modern Approach* (3rd ed.). Australia ; United Kingdom: Thomson/South-Western.
- World Bank. (1989). *Kenya: Report and Recommendations of the President of the International Development Association to the Executive Directors on the Proposed Financial Sector Adjustment Credit*. Washington D.C: World Bank.
- World Bank. (1994). *Adjustment in Africa: Reforms, Results and the Road Ahead*. Washington DC: World Bank.
- World Bank. (1998). *East Asia: The Road to Recovery*. Washington D.C.: World Bank.
- Wright, G., & Cracknell, D. (2008). The Market Led Revolution of Equity Bank. *Microsave Credit Note*, 63.
- Wright, R. (1998). *Two Ventrices of America's Early Financial Heart: Bank Lending in New York and Pennsylvania, 1781- 1830*. Paper presented at the Economic History Association Meetings, Durham, North Carolina.
- Yermack, D. (1996). Higher Market Valuation of Companies with a Small Board of Directors. *Journal of Financial Economics*, 40(2), 185-211.

Yin, R. (2003). *Applications of Case Study Research* (2nd ed. Vol. 34). Sage Publications.

Appendix 1: Major Bank Insolvencies in Africa 1980-2000

Country	Period	NPLs (% of total)	Fiscal Costs (% of GDP)	Output Loss (% of GDP)	Details
Benin	1988-1990	80	17	1.9	All three commercial banks collapsed
Burkina Faso	1988-1994	25	NA	45.2	3 banks were restructured and 2 other large banks continued to experience liquidity problems.
Burundi	1994-	25	NA	66.3	In 1995 one bank was liquidated
Cameroon	1987-1993	65	NA	118.1	Five banks closed and 3 banks restructured
Cameroon	1995-1998	30	NA	NA	Two banks closed and three banks restructured
Cape Verde	1993-	30			
Central African Republic	1976-1992	NA	NA	NA	Four banks liquidated
Central African Republic	1995-1999	40	NA	1.1	Two largest banks accounting for 90 percent of assets were restructured
Chad	1980s	NA	NA	NA	Banking sector experience insolvency problems
Chad	1992-	35	NA	37.2	
Congo, Dem. Republic of	1980s	NA	NA	NA	Banking sector experience insolvency problems
Congo, Dem. Republic of	1991-1992	NA	NA	81	Four state-owned banks were insolvent; a fifth bank was to be recapitalized with private participation
Congo, Dem. Republic of	1993-1996	75	NA	NA	Two state-owned banks have been liquidated and two other state banks

Country	Period	NPLs (% of total)	Fiscal Costs (% of GDP)	Output Loss (% of GDP)	Details
					privatized. In 1997, 12 banks were having serious financial difficulty
Cote d'Ivoire	1988-91	50	25	NA	Four large banks accounting for 90 percentage of assets insolvent. Six government banks closed.
Djibouti	1991-1993	NA	NA	22.6	Two of six commercial banks ceased operations in 1991-1992. Other banks experienced difficulties.
Ghana	1982-89	35	6	15.8	7 out of 11 banks were insolvent and had to be recapitalized
Guinea	1985,	NA	3	NA	6 banks accounting for 99% of deposits were deemed insolvent.
Guinea	1993-94	45	NA	NA	2 banks deemed insolvent
Kenya	1985-89, 1992, 1993-95, 1998-2003				See details in Chapter 4
Madagascar	1988	25	NA	NA	Government absorbed losses of NPLs and recapitalized loans
Mali	1987	75	NA	5.7%	Largest commercial bank declared insolvent
Mauritania	1983-93	70	15	NA	5 major banks experienced liquidity and insolvency issues
Mozambique	1987 –	NA	NA	NA	Main commercial bank

Country	Period	NPLs (% of total)	Fiscal Costs (% of GDP)	Output Loss (% of GDP)	Details
	1997				became insolvent.
Nigeria	1990s	77	NA	0.4	Almost half the bank in the country were insolvent.
Senegal	1988-91	50	17	25.4	7 banks closed accounting for 30% of total assets
Swaziland	1995			21.6	3 banks had to be taken over by the government
Tanzania	1987	70	10	NA	All the largest financial institutions had half their portfolio as non-performing
Tanzania	1995	NA	NA	NA	National Bank of Commerce accounting for 95% of the banking system assets was insolvent.
Togo	1993-1997	NA	NA	27.7	Whole sector experienced solvency problems
Uganda	1994-2000	NA	NA	NA	About half the banks experienced solvency problems and 3 banks were closed
Zambia	1995	NA	1.4	0.5	One bank accounting for 13% of total assets was declared insolvent

Source: Caprio, G., Klingebiel, D., Laeven, L., & Noguera, G. (2005). Banking Crisis Database. In P. Honohan & L. Laeven (Eds.), *Systemic Financial Crises : Containment and Resolution*. Cambridge: Cambridge University Press.

Notes:- NA – means not available

Appendix 2: Summary and Full List of Semi-Structured Interview Questions

Broad Question Areas	Sub Section	Q No From	Q No To
Lending Relationship	General	1	2
Lending Relationship	Ex-Ante Decision Making	3	22
Lending Relationship	Ex-Post Monitoring	23	26
Lending Relationship	Non-Performing Loans	27	37
Deposit Mobilization	Liability Management	38	42
Portfolio Management	Asset - Liability Management / Liquidity	43	45
Other Assets	Investment In Other Assets	46	47
Deposit Mobilization	Cost Of Funds	48	48
Portfolio Management	Asset - Liability Management / Liquidity	49	51
Corporate Governance	General	52	61
Corporate Governance	Market Discipline	62	64
Regulation	Regulation	65	70
Other	General	71	72

1. What proportion of assets in long term / short term
2. What industries do you target / have a niche
3. Do you have a set credit manual If no, who other guidelines do you use If yes, is the credit manual adequate
4. What are the steps that take place before a credit is granted
5. What is the chain in the decision making
6. Is decision made at branch level or head office level
7. What information do you get from a potential client, what quantitative / hard / financial information do you gather and how is it analyzed
8. How can you be sure that the figures being show in financial statements are accurate
9. What qualitative / soft / personal information do you gather and how is it analyzed
10. Do you visit client offices / businesses
11. What is the role of collateral in granting a loans, what percentage of loans are non-secure
12. Are there cases when a client can meet all the set requirements but a loan is still not granted, why would this happen
13. Are there cases when a client does not meet the set requirements but a loan is still granted, why would this happen
14. How can you be sure that the client you are granting a loan to was not rejected by another bank
15. What is the most influential information in the ultimate decision on credits
16. What procedures do you have to check the legal requirements of the loan

17. Is there a large overlap between the clients who are depositors and clients who are borrowers
18. On average how long are your relationships with your clients
19. What percentage of loans granted in a year are new clients compared to old clients
20. Do you feel restricted within an ethnic group in terms of your market
21. From your experience what makes the difference between a good loan and a bad loan
22. What is the level of insider lending in your banks, how are insider loans allocated
23. What sort of on-going information do you collect once a loan has been disbursed
24. Do you have a set procedure when dealing with bad loans
25. Is the decision made at branch level or head office level
26. Can you detect that a loan may go bad before it actually does
27. Do you think the non-performing clients are having genuine business difficulties or did they not disclose some information to you
28. Are there any specific sectors in which you experience higher NPLs
29. Main reason for trend in NPLs
30. On average after how long does a loan become NPL
31. NPLs mainly new clients or old clients
32. Were you not able to get proper credit ref
33. Difficulty in finding credit worthy borrowers
34. Problems with internal controls
35. Problems with judicial system, what are the legal or political impediments in enforcing contracts and recovering collateral, how long are the average cases that are pending
36. Of total operating costs what % is the legal cost
37. Have you had any cases of successful restructuring
38. What are your target depositors
39. Constraints in raising deposits
40. What proportion of accounts are in savings accounts vs. term deposits
41. What is the number of depositors you have
42. What is average term of your term deposits
43. How do you overcome the inherent problem of short term liability structures vs. long term asset structures
44. How do you manage liquidity
45. Do you think there is excess liquidity in the Kenyan market, what are the main reasons for liquidity

46. Is there any investment in equities
47. Off balance sheet activities
48. What is the main determinant of your cost of funds
49. What other risks besides credit risk are important and how do you manage these
Stress tests
50. Do you use the interbank market
51. Do you use the CBK discount facilities
52. History of the bank, how business started
53. Ownership structure, related parties
54. What is the board size and how often does the board meet
55. What is the organization decision making structure, what committees do you have in
place
56. How are board members identified and chosen
57. What drives corporate governance - domestic regulation, foreign regulation
international financial markets, domestic financial markets, individual banks
58. How are disputes about strategy at board level resolved
59. What sort of incentive structure do you have for management to align their interests
with shareholders
60. What are the check and balances on different decision makers
61. Are there any checks and balances on insider lending
62. Do you feel that there is a significant threat of takeover that disciplines management
63. How have recent moves to increase public knowledge of bank financial health
affected the market
64. How do you make decisions on IT investment
65. What do you think of the current capital requirements Are they sufficient to prevent
excessive risk taking
66. Do you use the data you generate for CBK reporting for your own internal decision
making
67. How do you prepare for on-site and off site supervision
68. Have CBK prudential guidelines and risk guidelines helped you
69. What is the cost of compliance to new regulations and are the costs justified
70. General regulation
71. Human resources constraint
72. Other point miscellaneous

Appendix 3: Variables in Financial Statements Database for Kenyan Banks

1	Total Assets
2	Total Liabilities
3	Net Assets (Shareholders' funds or capital)
4	Customer deposits
5	Other deposits
6	Total deposits
7	Borrowed funds
8	Loans & advances to customers (net of provisions)
9	Total Loans & advances to customers
10	Cash & Balances with the CBK
11	Government securities
12	Deposits and balances due from banking institutions (Placements with other banks)
13	Government Securities & Placement with other banks
14	Cash & Balances with the CBK
15	Interest on loans & Advances
16	Interest on Government securities
17	Interest on deposits and placements & bank balances with banking institutions
18	Other interest income
19	Total Interest income
20	Net interest income
21	Foreign Exchange Earnings
22	Fees & Commissions Income
23	Net Fees & Commissions income
24	Other Operating income(including gains from dealings in securities & disposal or change in carrying amounts of investment securities)
25	Total net Operating income
26	Other non-operating income(includes dividends)
27	Total Income
28	Interest on Customer Deposits
29	Interest on borrowed funds (and deposits and placements from other banks)
30	Other interest expense
31	Total interest expense
32	Fees & Commissions expenses
33	General administrative expenses
34	Total Operating expense
35	Other non-operating expenses
36	Total expenditure
37	Operating profits before provisions
38	Losses on loans and advances
39	Exceptional Items/Provisions for other losses and expenses

40	Profit Before Tax (after exceptional Item)
41	Total Provisions and interest in suspense for loans and advances
42	Non-performing loans and advances (Net of provisions and interest in suspense)
43	Provisions - specific & interests in suspense
44	Total non-performing loans and advances (less general provisions)
45	Realisable Value of securities
46	Net NPL exposure (excess)
47	Directors, shareholders & Associates
48	Employees
49	Total insider loans
50	Core Capital (Bank)
51	Supplementary capital (Bank)
52	Total Capital
53	Quick Assets
54	Total Risk weighted assets

Appendix 4: Variables in Corporate Governance Database for Kenyan Banks

	Corporate Governance Database (CGD)
	Data on all banks from 2000 - 2005
1	Weighted average interest on insider loans
2	Auditors Remuneration
3	Directors Emoluments
4	No of directors
5	No of Executive Directors
6	Non of non-Executive Directors
7	Proportion of non-executive directors
8	Board Credit Committee Existing
9	Board Audit Committee Existing
10	Non executive Director in audit committee
11	Non executive Director in credit committee
12	Corp Gov Statement
13	Shareholder (% controlled by top 3 shareholders)
14	Executive Chairman

Appendix 5: Summary of Stages of Banking Development

Stage 1: Pure financial intermediation
<ul style="list-style-type: none"> • Banks lend out savings • Payment in commodity money • No bank multiplier • Saving precedes investment
Stage 2: Bank deposits used as money
<ul style="list-style-type: none"> • Convenient to use paper money as means of payment • Reduced drain on bank reserves • Multiplier process possible • Bank credit creation with fractional reserves • Investment can now precede saving
Stage 3: Inter-bank lending
<ul style="list-style-type: none"> • Credit creation still constrained by reserves • Risk of reserves loss offset by development of inter-bank lending • Multiplier process works more quickly • Multiplier larger because banks can hold lower reserves
Stage 4: Lender-of-last-resort facility
<ul style="list-style-type: none"> • Central bank perceives need to promote confidence in banking system • Lender-of-last-resort facility provided if inter-bank lending inadequate • Reserves now respond to demand • Credit creation freed from reserves constraint
Stage 5: Liability management
<ul style="list-style-type: none"> • Competition from non-bank financial intermediaries drives struggle over market share • Banks actively supply credit and seek deposits • Competition over deposits pushes up interest rates, adding to cost-push inflation and encouraging industrial concentration as marginal firms fail cover costs • Credit expansion diverges from real economic activity
Stage 6: Securitisation
<ul style="list-style-type: none"> • Capital adequacy ratios introduced to curtail credit • Banks have an increasing proportion of bad loans because of over-lending in Stage 5 • Securitisation of bank assets • Increase in off-balance sheet activity • Drive to liquidity • Banks are now highly vulnerable to market fluctuations in value of securities as well as in capacity to raise capital
Stage 7: Market structural diffusion
<ul style="list-style-type: none"> • Trend to universalization in financial services: diffusion between retail and investment banking • Competitive pressure due to deregulation • Increased emphasis on services requiring increased marketing • Structural regulation being replaced by supervisory re-regulation, addressing moral hazard issues, off-balance sheet activities, global diffusion

Source: Ruziev, K. (2006). *Money and Banks in Transition Economies: The Case of Uzbekistan*. PhD. University of Stirling, Stirling, Scotland.

Appendix 6: Plea for Pluralistic and Rigorous Economics

Announcement

A PLEA FOR A PLURALISTIC AND RIGOROUS ECONOMICS

"We the undersigned are concerned with the threat to economic science posed by intellectual monopoly. Economists today enforce a monopoly of method or core assumptions, often defended on no better ground than that it constitutes the 'mainstream'. Economists will advocate free competition, but will not practice it in the marketplace of ideas."

"Consequently, we call for a new spirit of pluralism in economics, involving critical conversation and tolerant communication between different approaches. Such pluralism should not undermine the standards of rigor; an economics that requires itself to face all the arguments will be a more, not a less, rigorous science."

"We believe that the new pluralism should be reflected in the character of scientific debate, in the range of contributions in its journals, and in the training and hiring of economists."

These leading names have signed the above text:

Abramovitz, Moses	Galbraith, J.K.	Modigliani, Franco*
Arthur, W. Brian	Georgescu-Roegen, N.	Nelson, Richard
Axelrod, Robert	Goodwin, Richard	Olson, Mancur
Blaug, Mark	Grainger, Clive W.J.	Pasinetti, Luigi
Boulding, Kenneth	Grandmont, Jean-Michel	Perlman, Mark
Cowling, Keith	Harcourt, Geoffrey	Rothschild, Kurt
Cyert, Richard M.	Heilbroner, Robert	Samuelson, Paul*
Davidson, Paul	Hirschman, Albert	Shubik, Martin
Day, Richard	Kindleberger, Charles	Simon, Herbert*
Deane, Phyllis	Kornai, Janos	Spanos, Aris
Denison, Edward	Laidler, David	Tinbergen, Jan*
Desai, Meghnad	Leibenstein, Harvey	Tsuru, Shigeto
Freeman, Christopher	Matthews, R.C.O.	Vickers, Douglas
Frey, Bruno	Mayer, Thomas	Weintraub, Roy
Furubotn, Eirik	Minsky, Hyman	[Nobel Laureates = *]

This appeal is organized by Geoffrey Hodgson (UK), Uskali Mäki (Finland) and Donald McCloskey (USA). It is hoped that it will stimulate discussion concerning the need for greater diversity and pluralism, both in theory and method, in economic science.

Correspondence should be sent to:

Geoffrey M. Hodgson, Department of Economics and Government,
Newcastle Polytechnic, Newcastle upon Tyne NE1 8ST, UK.

Please mention THE AMERICAN ECONOMIC REVIEW When Writing to Advertisers

**Appendix 7: Kenya GDP Growth, Inflation, Exchange Rates and T-Bill Rates
(1990-2005)**

YEAR	GDP growth rate (%)	Inflation rate - consumer prices annual %	Exchange rate to \$ - period average	Exchange rate to \$ - end of year	T bill rate - annual average %
1990	4.19	17.78	23	24	NA
1991	1.44	20.08	28	28	17
1992	-0.80	27.33	32	36	18
1993	0.35	45.98	58	68	56
1994	2.63	28.81	56	45	25
1995	4.41	1.55	51	56	19
1996	4.15	8.86	57	55	23
1997	0.47	11.36	59	63	22
1998	3.29	6.72	60	62	23
1999	2.31	5.74	70	73	13
2000	0.60	9.98	76	78	12
2001	3.78	5.74	79	79	13
2002	0.55	1.96	79	77	9
2003	2.93	9.82	76	76	4
2004	5.10	11.62	79	77	3
2005	5.91	10.31	76	72	8

Appendix 8: Methodology of Decomposition of Interest Rate Spreads used in Beck and Fuchs (2004)

i_L is defined as loan interest rate and i_D as interest rate on time deposits, using the one-year rates, averaged over all banks and over the year 2002.

The decomposition is based on the identity that loans have to be financed with available deposits, i.e. deposits net of reserves with the central bank, or $L = (1 - R)*D$, where L is loans, R is reserve requirements, and D is deposits.

The weighted average lending rate across loans of different maturities and a weighted average deposit rate across demand, savings and time deposits of different maturities is calculated. It is assumed that there is a similar maturity structure across different currencies as disaggregated loan and deposit maturity distribution data for local and foreign currency is unavailable.

LLP is defined as loans loss provisions net of recoveries relative to loans. It is assumed that local and foreign currency loans have similar default rates.

OC are the overhead costs attributable to loans. The share of overhead costs attributable to loans is by calculated using the ratio of loan interest revenue in total revenue. Again it is assumed that size ratio is the same across local and foreign currency loans.

The tax rate τ is set at 30 percent as this is official corporate tax rate and also because , banks indicated to the World Bank mission that tax payments constitute around 30 percent of profits.

The profit margin (profit relative to loans) was then calculated as residual after accounting for the other four components:

$$PM = (1-\tau)*(i_L-LLP - i_D/(1 - R) - OC)$$

Rearranging gives the sum of the different components of the interest rate spread:

$$i_L - i_D = LLP + i_D*R/(1 - R) + OC + PM + \tau*[PM - LLP - i_D*R/(1 - R) - OC]$$

Appendix 9: Return on Assets by Segment 2000 - 2005

Return on Assets							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	2%	3%	3%	3%	3%	3%	3%
GOB	-2%	0%	0%	2%	1%	3%	1%
LPOB	2%	3%	3%	4%	3%	3%	3%
SPOB	-1%	0%	1%	0%	0%	1%	0%
Total	0%	2%	2%	2%	2%	2%	1%

Source: Author's calculations

Appendix 10: Core Capital on Total Risk Weighted Assets by Segment 2000 - 2005

Core capital/total risk weighted assets							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB		27%	27%	28%	25%	26%	27%
GOB		13%	14%	26%	35%	28%	23%
LPOB		27%	26%	28%	24%	21%	25%
SPOB		30%	34%	31%	28%	28%	30%
Total		24%	25%	28%	28%	26%	28%

Source: Author's calculations

Appendix 11: Loans on Total Assets by Segment 2000 - 2005

Loans /Total Assets							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	38%	38%	36%	38%	44%	44%	40%
GOB	55%	54%	55%	52%	49%	51%	53%
LPOB	51%	50%	50%	49%	51%	54%	50%
SPOB	51%	51%	52%	53%	54%	53%	52%
Total	49%	48%	48%	48%	49%	50%	49%

Source: Author's calculations

Appendix 12: Government Securities on Total Loans by Segment 2000 - 2005

Government Securities /Total Loans							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	95%	116%	131%	157%	103%	101%	117%
GOB	11%	30%	16%	37%	30%	30%	26%
LPOB	35%	40%	40%	55%	37%	32%	38%
SPOB	24%	34%	38%	36%	28%	25%	31%
Total	41%	55%	56%	71%	50%	47%	53%

Source: Author's calculations

Appendix 13: Total Loans on Total Deposits by Segment 2000 - 2005

Total Loans/Total Deposits							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	61%	61%	52%	53%	60%	59%	58%
GOB	312%	145%	143%	110%	109%	102%	153%
LPOB	88%	81%	78%	81%	74%	96%	82%
SPOB	291%	173%	166%	112%	105%	98%	158%
Total	188%	115%	110%	89%	87%	89%	116%

Source: Author's calculations

Appendix 14: Non-Performing Loans by Segment 2000 - 2005

Total NPL/Total Loans							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	16%	11%	9%	7%	5%	6%	9%
GOB	58%	41%	49%	46%	45%	35%	46%
LPOB	30%	18%	17%	13%	10%	11%	16%
SPOB	39%	29%	26%	24%	25%	24%	28%
Total	36%	25%	25%	23%	21%	19%	22%

Source: Author's calculations

Appendix 15: Cost of Funds by Segment 2000 - 2005

Cost of funds							
SEGMENT	2000	2001	2002	2003	2004	2005	Average
FOB	5%	4%	3%	2%	1%	2%	3%
GOB	7%	6%	6%	3%	2%	2%	4%
LPOB	7%	6%	5%	3%	2%	5%	5%
SPOB	9%	7%	6%	4%	3%	4%	6%
Total	7%	6%	5%	3%	2%	3%	5%

Source: Author's calculations

Appendix 16: Number of Branches per Bank 2005

			2005
1	Barclays Bank of Kenya	FOB	49
2	Standard Chartered Bank	FOB	31
3	Citibank	FOB	3
4	Stanbic Bank	FOB	3
5	Bank of Baroda	FOB	7
6	Bank of India	FOB	2
7	Bank of Africa	FOB	2
8	Habib A.G. Zurich	FOB	5
9	K-Rep Bank	FOB	3
10	Habib Bank Ltd	FOB	6
11	Kenya Commercial Bank	GOB	113
12	National Bank of Kenya	GOB	24
13	Consolidated Bank	GOB	12
14	Development Bank of Kenya	GOB	1
15	Co-operative Bank of Kenya	LPOB	28
16	CFC Bank	LPOB	5
17	Commercial Bank of Africa	LPOB	15
18	NIC Bank	LPOB	3
19	I&M	LPOB	4
20	Diamond Trust	LPOB	3
21	Equity Bank	LPOB	2
22	Imperial Bank	LPOB	3
23	Trans-National Bank	LPOB	6
24	EABS Bank	SPOB	4
25	Fina Bank	SPOB	4
26	Prime Bank	SPOB	7
27	ABC Bank	SPOB	8
28	Giro Commercial Bank	SPOB	6
29	Guardian Bank	SPOB	6
30	Southern Credit Bank (Merged with Bullion Bank)	SPOB	5
31	Charterhouse Bank Ltd.	SPOB	1
32	Victoria Commercial Bank	SPOB	1
33	Middle East Bank	SPOB	3
34	Equatorial Commercial Bank	SPOB	3
35	Credit Bank	SPOB	3
36	Chase Bank	SPOB	2
37	Fidelity Commercial Bank	SPOB	1
38	Paramount Universal Bank	SPOB	3
39	Oriental Commercial Bank (formerly Delphis Bank)	SPOB	5
40	Dubai Bank (formerly Mashreq Bank)	SPOB	3
41	City Finance Bank	SPOB	1

Source: Author's calculations

Appendix 17: Average Number of Branches per Segment 2005

FOB	FOB Average	11
GOB	GOB Average	38
LPOB	LPOB Average	8
SPOB	SPOB Average	4

Source: Author's calculations

Appendix 18: Old Credit Analysis, Bank 6, SPOB (up to 2004)

BANK 6 SPOB

Date : 18.03.2004

NOTE TO THE CREDIT COMMITTEE

NAME OF BORROWER: [REDACTED]

PURPOSE OF REQUEST AND DETAILED DESCRIPTION OF THE PROPOSAL:

Proposal for increase in regular OD limit by K.Shs 3,000,000, i.e. from K.Shs 3,000,000 to K.Shs 6,000,000. The increased limit to be valid for 28.02.05, changed from the anniversary date of 31.10.2004.

Nature of facility	Position as at 17.03.2004	Previous limits (K.Shs)	Proposed limit	Variation
OD	9,472,889* Dr	3,000,000	6,000,000	3,000,000

*Includes inward cheques, however temporary excess up to K.Shs 8,000,000 authorised till 31.03.2004. Customer has requested for a continuation of excess for a further period of 1 month.

Expiry Date	OD : 28.02.2005
-------------	-----------------

Background information/activity

Company is operating business outlet within CBD and deals in general merchandise. Existing regular OD limit of K.Shs 3,000,000 was sanctioned in May 1999 and conduct of account has been satisfactory. Regular OD limit is adhered to and there are good swings in outstanding balances. Moreover account turnover is high and deposits of K.Shs 1,000,000 on average are made occasionally.

Due to increased volume of business, customer has requested for an increase in OD limit from K.Shs 3,000,000 to K.Shs 6,000,000. Requested additional working capital facility will be secured by supplemental debenture charge over all assets of the Co. Co. have also requested for a continuation of temporary excess up to K.Shs 8,000,000 for a further period of 1 month till 30.04.2004.

FINANCIAL HIGHLIGHTS

The Company's summarized key financial figures are shown below:

	12 months ended 30.09.2003 (unaudited)	30.09.2002	30.09.2001
Sales	242,189	256,872	247,741
Net Profit	925	194	415
Depreciation	N/A	1,313	587
Total Assets	51,404	55,963	53,515
Total Borrowings	3,000	5,933	9,661
Net worth	1,290	1,096	9,720
Debtors	6,984	7,079	9,713
Creditors	42,935	43,488	37,851

Comments on Financial Performance

Profitability : Gross margins over the period under review was satisfactory as costs of sales remained low. However net margins reduced slightly. It has been advised that there was significant improvement in sales registered during 3 months ended 31.12.03 of K.Shs 69.977m. On this trend Co. expects to sustain steady growth rate and hence sales will increase further.

Liquidity : Both creditors and debtors turnover improved as at 30.09.03. Total borrowings also reduced significantly during the period under review. Moreover there are Directors funds in the business K.Shs 5.069m (as at 30.09.03) which supplements the working capital.

Solvency : Total net worth is low, however net profits realized are being ploughed back into the business to supplement working capital and also augment capital base.

Future forecasts : Scope of increased volume of business especially in foreign exchange for imports

Relationship with [REDACTED] Ltd.

Period since relationship started : August 1999

Income earned :

Income Type (OD account)	Last 12 months ended 31.12.2003 (K.Shs)	Last 12 months ended 31.12.2002 (K.Shs)
Interest	924,110	1,272,196
Commission	114,247	7,851
Miscellaneous	72,085	50,019

Balances during last 12 months ended 31.12.2003

Account type	Maximum (K.Shs)	Minimum (K.Shs)
OD A/C	9,239,894 on 31.10.2003	770,929 on 28.02.2003

Credit Turnover for last 12 months ended 31.12.2003 :K.Shs 281,173,555

Relationship with other Banks : None

Previously Co. was dealing with [REDACTED] but have since shifted entire business to us.

Regarding collection from upcountry clients, it is being routed through [REDACTED].

SUMMARY OF RISK ANALYSIS

Strengths

Conduct of OD account is satisfactory with high account turnover

High volume of sales

Weaknesses

Working capital facility will be availed against debenture which is a weak collateral

Business is operated with very low margins. Nevertheless, Co. has sustained a steady growth rate over the years vis a vie a comfortable share of the business and hence high volumes

Security Held

General Debenture charge for K.Shs 3,000,000 over the entire assets of the Co value as at 30.09.2002

Book Value (K.Shs)

Fixed Assets	4,323,877
Stock	42,652,947
Debtors	7,079,414
TOTAL	54,056,238

(For lending purposes K.Shs 13,514,060, i.e. 25% of value)

Credit Agreement for K.Shs 3,000,000 executed under common seal of the Co. supported by Board Resolution

Individual Guarantee for K.Shs 3,000,000 each executed by the Directors of the Co.

Security Proposed

Supplemental debenture charge for K.Shs 3,000,000 over entire assets of the Co.

Credit agreement for K.Shs 6,000,000 executed by all the Directors of the Company supported by Board Resolution

Individual Guarantees for K.Shs 6,000,000 signed by each of the Directors of the Company

Recommendation & Justification

Going by the satisfactory track record, we recommend:

Continuation of temporary excess up to K.Shs 8,000,000 for a further period of 1 month, till 30.04.2004.

Review of overdraft facility with increase in limit by K.Shs 3,000,000, i.e. up to K.Shs 6,000,000 for a period till 28.02.2005

Interest to be levied at 13.5% p.a.

Commitment fees to be recovered at 1% p.a. on the renewed limit and the continued excess on pro rata basis

Security documents to be perfected as proposed.

██████████

██████████

SENIOR RELATIONSHIP OFFICER

RELATIONSHIP OFFICER

COMMENTS BY :

CHIEF OPERATING OFFICER

CREDIT COMMITTEE

Considered at the Credit Committee held on.....and
it was

resolved to approve the request/reject it/recommend it for approval to the Board of
Directors subject to :

Member

Member

Member

Date.....

Date.....

Date.....

Appendix 19: New Credit Analysis, Bank 6, SPOB (From 2004)

Customer :	Ltd	LAF :
CB/307/566		
Date : 14TH June 2006		

PROPOSAL

REQUIREMENTS/SECURITY

Requirement

Annual review, with continuation of existing overdraft limit with increase in limit to K.Shs 15 Million for a further period of 12 months up to 31.05.2006.

Security

All tangible security held is perfected and in place.

CREDIT POLICY

Complied with.

STRATEGY

Grow

RECOMMENDATION

Satisfactory conduct of account.

Successful track record of over 9 years.

No history of default.

Satisfactory financials.

Company is deemed to have the ability to service its commitments.

In view of the above, we recommend renewal of credit facility as proposed.

RELATIONSHIP MANAGER

ATTACHMENTS

YES/NO

Fact Sheet	Yes
Business Risk	Yes
Financial Risk	Yes
Management Risk	Yes
Structural Risk	Yes
Security Risk	Yes
Account Performance Risk	Yes
Financial Spread Sheet	Yes
Other Bank Reports	Yes – Monthly Turnover
Balance Sheet	Yes
Credit Grade Score Card	Yes

ATTACHMENT NO. 1**FACT SHEET****HISTORY AND PROGRESS TO DATE**

Established in 1975, the company deals in wholesale and retail of footwear, hardware and general merchandise. They have 2 outlets located in the CBD and Gikomba Area respectively.

Our relationship with the customer dates back to 1996 and we have a satisfactory track record.

OWNERSHIP / ORGANIZATION STRUCTURE

The following are Directors of the Company who are also involved in the day to day activities of the business.

XX	62.5%
XX	37.5%
XX	(Director Only)
XX	(Director Only)

ACTIVITIES / PRODUCTS

The main activity is wholesale and retail of footwear, hardware and general merchandise. Main suppliers include Mabati Rolling Mills Ltd, Budget Shoes Ltd and Technoplast Ltd to name a few. Credit extended is up to 60 days. Company has a good client base with whom they maintain cordial business relationship with 70% of sales on cash basis and 30% on credit basis.

The Company wants to start importing hardware and other items including nails, utensils from China where suppliers will give the Co. open credit. Goods will be of higher quality and cheaper in price.

MARKETS

Limited to Kenya with core business in Nairobi, however goods are sold on wholesale basis to upcountry markets through agents.

COMPETITORS

The company is faced with competition by other wholesale businesses around the same area. However they do not pose any threat as :

There is demand for the products and they have control of comfortable market share going by high sales registered.

Company has also mitigated risk by purchasing goods in bulk to take advantage of discounted prices.

Company will start importing items from China which are of better quality and cheaper in price.

LOCATION OF BUSINESS

Company is operating two business outlets dealing in footwear in one shop located within CBD and hardware and general merchandise at the other shop located at Gikomba Area.

The business premises which is owner occupied in Gikomba Area is comprised of a 3 floor building with the ground floor as the shop and 2 floors used for storage of goods.

MANAGEMENT, LABOUR & OTHER RESOURCES

This is a family business with Directors of the Company being father and sons assisted by 7 permanent staff. Mr XXX is the key decision maker of the business whilst the other Directors are involved in the day to day running of the business.

Accounting is handled by a qualified staff whereas marketing is done by the Directors themselves.

Monitoring and control of the business using appropriate MIS is not a problem as they are ably assisted by skilled and experienced staff and have the right computer software to generate requisite and timely MIS.

Total Staff – 7 permanent staff

ATTACHMENT NO. 2

BUSINESS RISK

Strengths

Comfortable market share and products will be sold at attractive price compared to those offered by their main competitors

Satisfactory performance as depicted by high sales registered.

Directors well versed in the line of business with experience of over 20 years.

Have an excellent relationship with suppliers and hence enjoy credit periods extending up to 90 days.

Weaknesses

Low equity, however Directors have assured to increase paid up capital during next financial year.

Though this is admittedly a very competitive industry with many players, the Co. however, has maintained long term relationships with both buyers and suppliers.

Turnover and margins heavily dependent upon successful negotiation of large orders to take advantage of discount prices. (Mitigated as many are repeat orders, and relationship with both suppliers and buyers is well established, with OD facility used to purchase stocks.)

Opportunities

There is a large untapped market for products that Company sells upcountry which Company is looking into through importation of hardware and other items from China.

Threats

Kenya has generally high interest rates. However benchmark interest rates are acceptably stable for trade purposes.

Conclusion

With strengths and opportunities outweighing the weaknesses and threats, the business risk can be termed 'acceptable'.

ATTACHMENT NO. 3

FINANCIAL RISK

Balance Sheet Dated	31.12.2005
Auditors	
Standing & Reputation	Acceptable
Accounting Principles	International Standards on Auditing
Auditor's Certificate Qualified	No

OTHER BANK AND FINANCIAL LINES

Company multi banks with Kenya Commercial Bank Ltd and Barclays Bank Ltd. Accounts were opened due to banking from remote areas by customers, however we have advised customer of our arrangements with Co-operative Bank. Moreover no credit facilities are availed by the said banks.

BALANCE SHEET ANALYSIS

(KES 000)

Narration	2003	2004	2005
Sales	116,675	113,814	82,743
Gross Profit	7,371	7,967	7,860
Net Profit	541	435	-137
NCFO	(1,380)	(383)	(527)
Net Worth	4,278	4,716	4,578
Total ST Borrowings	7,087	7,410	8,661
Gearing	1.66	1.57	1.89

a. Liquidity

Sales have been on a declining trend during the last three years. During last financial year, sales reduced by 27% mainly due to Co. getting out slowly from footwear business. However with the start of importation of materials from China, Co. is optimistic that sales will improve.

b. Working Capital

70% of sales are on cash basis however 30% are extended credit of maximum 60 days hence debtors turnover of 36 days. Creditors turnover of 117 days is high however this is as at a particular day. Cash flow is satisfactory as depicted by large fluctuations in the outstanding balances in the account.

With majority of the stocks being within 60-90 days, the stock position is acceptable in view of the nature of the products being dealt with.

c. Profitability

Due to a significant drop in sales last year, Co. incurred losses as at 31.12.2005 which will be turned around by the next financial year with introduction of new lines.

d. Gearing

Net worth is low however previous years profits are retained in the business. Moreover we have advised Directors to increase share capital during next financial year.

e. Post Balance Sheet Events

Turnover in the account with us for 5 months ended 31.05.2006 is reflected at 45.7 Million which is high.

f. Projections

Demand for the products are high and there is large potential for growth and Directors are optimistic that next financial year will show an even better performance.

g. Summary / Conclusion

The Financial Risk is considered 'acceptable'.

ATTACHMENT NO. 4

MANAGEMENT RISK

All Directors are involved in day to day operations of the business together. Mr XXX is the key decision maker of the business and well versed in this line. Due to this direct participation of the owner in business, there is no mismanagement.

Directors are assisted by 7 experienced staff.

SUCCESSION RISK

Company is jointly managed mainly by all Directors, and moreover Company operations can continue in the absence of the Directors with the assistance of the employees who are conversant with the business.

Based on the above, the management risk is termed as 'acceptable'.

ATTACHMENT NO. 5**STRUCTURAL RISK**

The overdraft facility is need based and structured as per customer requirement mainly for working capital purposes. Conduct of the account is satisfactory with regular limit being respected at all times and a high turnover reflected. Client has requested for an increase in facility due to introduction of new line, that is importation of materials from China. Following discussions with the client, Mr xxx advised that he increase is only for emergency used and will not be utilized at all times.

Facility is availed against tangible security, and OD account is well conducted hence, the Structural Risk is 'acceptable'.

ATTACHMENT NO. 6**SECURITY RISK**

The following support for OD facility is held by XXX Bank:

FLC for K.Shs 10 Million on commercial property LR No 209/9791/21 on Directors of the Co.

Individual Guarantees for K.Shs 13 Million by all Directors of the Company viz XXX Board Resolution authorizing Co. to borrow up to K.Shs 15 Million.

NB : Client is not agreeable to upstamping of legal charge to K.Shs 15 Million as they advised that facility is only required for emergency use and will not be fully utilized. However fresh internal security documents of K.Shs 15 Million shall be obtained.

With a satisfactory and trouble free experience of over 9 years with XXX Bank, the above mentioned support / security risk is considered 'acceptable'.

ATTACHMENT NO. 7**ACCOUNT PERFORMANCE RISK**

Account conduct satisfactory with large fluctuations in the account and regular limit adhered to at all times.

Based on our dealings with XXXX over the years and current financial information in our possession the company is deemed to have the ability service all of its commitments.

Account Performance Risk is 'acceptable'

Risk/Reward :

Our earnings from the relationship in 2005 was KES 1.2 Million and for 5 months ended 31.05.2006 earnings were KES 0.527 Million which is satisfactory.

LIMIT APPLICATION NO: CB/307/566		DATE: 14th June 2006																																																					
NEW :	AMENDED :	ARM:																																																					
ADDITIONAL :	WATCH :	STRATEGY: GROW																																																					
RENEWAL :	X	S/STANDARD:																																																					
BRANCH : KIMATHI STREET, NBI																																																							
BORROWER :		GROUP NAME : N/A																																																					
BUSINESS :		CREDIT GRADE : R5																																																					
WHOLESALE AND RETAILERS		INDUSTRY SECTOR: WHOLESALE AND RETAILERS																																																					
FOOTWEAR, HARDWARE AND		CREDIT POLICY COMPLIANCE : YES																																																					
GENERAL MERCHANDISE		NATURE OF BREACH: N/A																																																					
BORROWING RELN. SINCE : 18TH MARCH 1996		REVENUE KES '000																																																					
DATE OF ESTABLISHMENT: 1975		Exchange																																																					
INDUSTRY SECTOR : WHOLESALE AND RETAILERS		Commission																																																					
CREDIT GRADE/SEC : R5/66%		Net Interest																																																					
NEXT REVIEW DATE : 31ST MAY 2007		Others																																																					
		Total																																																					
		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td>2003</td> <td>2005</td> <td>2005</td> </tr> <tr> <td>N/A</td> <td>N/A</td> <td>N/A</td> </tr> <tr> <td></td> <td>95</td> <td>35</td> </tr> <tr> <td></td> <td>1,150</td> <td>492</td> </tr> <tr> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td>1,245</td> <td>527</td> </tr> </table>		2003	2005	2005	N/A	N/A	N/A		95	35		1,150	492					1,245	527																																		
2003	2005	2005																																																					
N/A	N/A	N/A																																																					
	95	35																																																					
	1,150	492																																																					
	1,245	527																																																					
CONNECTIONS & OWNERSHIP <p>Limited Liability concern of Directors/Shareholders:</p>																																																							
BALANCE SHEET/PROFIT & LOSS - KEY FIGURES (KES '000) <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th>YEAR</th> <th>31.12.03</th> <th>31.12.04</th> <th>31.12.05</th> </tr> <tr><td>Sales</td><td>116,675</td><td>113,814</td><td>82,743</td></tr> <tr><td>Gross Profit</td><td>7,371</td><td>7,967</td><td>7,860</td></tr> <tr><td>Net Profit</td><td>541</td><td>435</td><td>-137</td></tr> <tr><td>NCFO</td><td>-1,380</td><td>-393</td><td>-527</td></tr> <tr><td>S.T. Borrowings</td><td>7,087</td><td>7,410</td><td>8,661</td></tr> <tr><td>Current Assets</td><td>27,394</td><td>30,372</td><td>30,140</td></tr> <tr><td>Current Liabilities</td><td>33,256</td><td>35,906</td><td>35,780</td></tr> <tr><td>Fixed Assets</td><td>10,142</td><td>10,250</td><td>10,218</td></tr> <tr><td>Term Liabilities</td><td>0</td><td>0</td><td>0</td></tr> <tr><td>Capital</td><td>16</td><td>16</td><td>16</td></tr> <tr><td>Retained Profit</td><td>4,262</td><td>4,700</td><td>4562</td></tr> <tr><td>Net Worth</td><td>4,278</td><td>4,716</td><td>4,578</td></tr> </table>				YEAR	31.12.03	31.12.04	31.12.05	Sales	116,675	113,814	82,743	Gross Profit	7,371	7,967	7,860	Net Profit	541	435	-137	NCFO	-1,380	-393	-527	S.T. Borrowings	7,087	7,410	8,661	Current Assets	27,394	30,372	30,140	Current Liabilities	33,256	35,906	35,780	Fixed Assets	10,142	10,250	10,218	Term Liabilities	0	0	0	Capital	16	16	16	Retained Profit	4,262	4,700	4562	Net Worth	4,278	4,716	4,578
YEAR	31.12.03	31.12.04	31.12.05																																																				
Sales	116,675	113,814	82,743																																																				
Gross Profit	7,371	7,967	7,860																																																				
Net Profit	541	435	-137																																																				
NCFO	-1,380	-393	-527																																																				
S.T. Borrowings	7,087	7,410	8,661																																																				
Current Assets	27,394	30,372	30,140																																																				
Current Liabilities	33,256	35,906	35,780																																																				
Fixed Assets	10,142	10,250	10,218																																																				
Term Liabilities	0	0	0																																																				
Capital	16	16	16																																																				
Retained Profit	4,262	4,700	4562																																																				
Net Worth	4,278	4,716	4,578																																																				
TOTAL EXISTING FACILITIES		FACILITIES SOUGHT																																																					
KES 13,000,000		KES 15,000,000																																																					
		VALUE OF SECURITY (KES) Tangible 10,000,000 Intangible 0 TOTAL 10,000,000																																																					
GROUP TOTAL KES 15,000,000		TOTAL OTHER BANK LINES N/A																																																					
RECOMMENDED RELATIONSHIP MANAGER Date:		The above detailed facilities are approved subject to any conditions recorded in the appraisal. MANAGING DIRECTOR Date:																																																					
HEAD OF BUSINESS BANKING Date:																																																							

		LAF : CB/307/566	
		Date: 14.06.2006	
Total Existing Approved Facilities	Total Facilities Sought	Type, Terms (including repayment, interest rate & margins Purpose)	
KES 13,000,000	KES : 15,000,000	(A) <u>GENERAL</u>	
		1) a Limit Usage : Ordinary	
		Limit Type : Overdraft	
		Purpose : Working Capital Requirements	
		Tenor : 31.05.2007	
		Interest : Base + 1.25%, I.e. 14.5% p.a. Subject to variation	
		Processing Fee : Waived	
KES 13,000,000	KES 15,000,000	TOTAL	

Customer: \									
LAF NO: CB/307/566									
Date: 14.06.2006									
SECURITY:									
Sr. No.	Type	T/I	Value KES	F.S.V. KES	Limits Covered	Basis of Valuation	Insurance & Rent/Rates	Held	Y/N
1	Fic for K.Shs 10m on commercial property LR No 209/9791/21 ino Directors	I	22m	13.2m	ALL	Valuation Report dated 12.02.2004 by	Y	Y*	
2	Personal Guarantees of Directors viz	I	10m	N/A	ALL	N/A	N/A	Y**	
3	Board Resolution authorising Co. to borrow	I	10m	N/A	ALL	N/A	N/A	Y**	
Total (Tangible only)			22M	13.2M					
Intangible			NIL	22M					
<p>* Discussions were held to increase charge to K.Shs 15m however Co. is not agreeable to the same</p> <p>** To obtain fresh Guarantees of K.Shs 15m</p> <p>Group Exposure : N/A</p> <p>DISPENSATIONS SOUGHT:</p> <p>Processing fees to continue to be waived</p> <p>COVENANTS:</p> <p>1) Quarterly submission of age-wise analysis of debtors and creditors (to be submitted)</p> <p>2) Quarterly management accounts and projected cash flows (to be submitted)</p> <p>3) To increase share capital to atleast K.Shs 1m by next financial year</p> <p>ALL TANGIBLE SECURITY HELD IS PERFECTED AND IN PLACE</p>									

BALANCE SHEET ANALYSIS	<u>31.12.03</u>	<u>31.12.04</u>	<u>31.12.05</u>
Trade Debtors	9,810	8,371	8,081
Trade Bills Receivable			
Total Accounts Receivable	9,810	8,371	8,081
Stocks- Raw Material			
Finished Goods	17,309	21,870	21,910
WIP			
Goods in transit			
Total Stocks	17,309	21,870	21,910
Trade Creditors	25,150	27,319	26,578
Trade Bills Payable			
Total Accounts Payable	25,150	27,319	26,578
Net Working Assets	1,969	2,922	3,413
Cash & Bank	274	131	149
Marketable Investments			
Total Cash Assets	274	131	149
Due to Banks (O/D, T/R)	7,087	7,410	8,661
Due to Banks-S.T due in 1 yr			
Total S.T. Borrowings	7,087	7,410	8,661
Net Cash Assets	-6,813	-7,279	-8,512
Other Debtors & Prepayments			
Due from related co's			
Other Current Assets	0	0	0
Other Creditors & Accruals			
Directors Accounts	1,020	1,177	541
Other Liabilities			
Other Current Liabilities	1,020	1,177	541
Net Current Assets	-5,864	-5,534	-5,640
Total Current Liabilities	33,257	35,906	35,780
Land & Buildings	9,563	9,563	9,563
Plant & Machinery			
Motor Vehicles	515	631	606
Furniture & Fixtures	64	56	49
Inter company debts			
Long Tern Receivables			
Total Fixed Assets			
Term Assets	10,142	10,250	10,218

BALANCE SHEET ANALYSIS cont..		<u>31.12.03</u>	<u>31.12.04</u>	<u>31.12.05</u>
Long Term Payables				
Loans - Long term				
-Medium**				
-Foreign Ccy				
Provision for Employee benefits			0	0
Term Liabilities		0	0	0
Net Assets		4,278	4,716	4,578
Net Worth		4,278	4,716	4,578
Share Capt - Ordinary		16	16	16
-Other				
Reserves - General				
- Partners Accounts				
- P & L		4,262	4,700	4,562
Shareholders Funds		4,278	4,716	4,578
Partners Loans				
Equity		0	0	0
Deduct Goodwill		0	0	0
Net Worth		4,278	4,716	4,578
Proof of NW (should=0)		-	-	-

PROFIT & LOSS STATEMENT				
		<u>31.12.03</u>	<u>31.12.04</u>	<u>31.12.05</u>
Sales		116,675	113,814	82,743
Cost Of Sales		109,304	105,847	74,883
Gross Profit		7,371	7,967	7,860
Selling&Gen Admn		3,276	3,735	3,780
Management Remuneration		3,360	3,360	3,360
Depreciation/ Amortization		48	125	101
Operating Profit		687	747	619
Other Income		720	720	720
Bad Debts written off				
Profit Before Int Tax		1,407	1,467	1,339
Interest		677	840	1,287
Profit Before Tax		730	627	52
Transfer to/ from Reserves		189	192	189
Earnings		541	435	-137
,+/-Extraordinary Item				
"+/-Exceptional Items				
Net Profit		541	435	-137
Management Fees/ Dividends				
Retained Profit		541	435	-137
Change in Net Worth			3	-1

HISTORICAL CASHFLOW STATEMENT			
	<u>31.12.03</u>	<u>31.12.04</u>	<u>31.12.05</u>
OPERATING SECTOR			
Sales	116,675	113,814	82,743
*Trade Debtors/Bills Receivable	-9,810	1,439	290
CASH FROM SALES	106,865	115,253	83,033
Cost of Sales	-109,304	-105,847	-74,883
*Stock	-17,309	-4,561	-40
*Trade Creditors/Bills Payables	25,150	2,169	-741
CASH-COST OF SALES	-101,463	-108,239	-75,664
CASH FROM W.C. CYCLE	5,402	7,014	7,369
Selling, General Admin Expense	-6,636	-7,095	-7,140
*Other Debtors/Prepayments	0	0	0
*Other Creditors/Accruals	0	0	0
CASH- SELL- ADMN EXP	-6,636	-7,095	-7,140
GROSS CASH FROM OPS	-1,234	-81	229
Interest	-677	-840	-1,287
Tax	-189	-192	-189
Dividends	0	0	0
CASH FROM OPS	-2,100	-1,113	-1,247
Non-Operating Income(Net)	720	720	720
NET CASH FROM OPS	-1,380	-393	-527
INVESTMENT SECTOR			
*Capital Expenditure	-10,190	-233	-69
*Investment Expenditure	0	0	0
*Other Intangibles	0	0	0
Extraordinary gains & losses	0	0	0
CASH BEFORE FUNDING	-11,570	-626	-596
FINANCING SECTOR			
*Due to banks	7,087	323	1,251
*Short Term Debt	0	0	0
*Term Debt	0	0	0
*Intercompany Debt	1,020	157	-636
*Directors C/A	0	0	0
*Equity & Share Premium	16	0	0
*Reserves Other	0	3	-1
MOVEMENT IN CASH ASSETS	-3,447	-143	18
*Cash & Bank	274	-143	18
*Investments Marketable	0	0	0
MOVEMENT IN CASH ASSETS	274	-143	18

RATIO ANALYSIS				
	31.12.03	31.12.04	31.12.05	
LIQUIDITY				
a)GCFO : Sales	(0.01)	(0.00)	0.00	
b)GCFO : Interest	(1.82)	(0.10)	0.18	
c)GCFO : S.T. DEBT + INT	(0.16)	(0.01)	0.02	
d)Current Ratio	0.82	0.85	0.84	
WORKING CAPITAL RATIOS				
Debtors : Sales * 365	31	27	36	
Stocks : Sales * 365	54	70	97	
Creditors : Sales * 365	79	88	117	
N.W.A : Sales * 365	6	9	15	
PROFITABILITY				
Gross Profit Margin	6.32%	7.00%	9.50%	
Operating Profit Margin	0.59%	0.66%	0.75%	
GEARING				
S.T Debt : Net Worth	1.66	1.57	1.89	
TOTAL DEBT : NET WORTH	1.66	1.57	1.89	
TOTAL LIAB : NET WORTH	7.77	7.61	7.82	
OTHERS				
Sales : Term Assets	11.50	11.10	8.10	
Sales : Total Assets	3.11	2.80	2.05	

Appendix 20: Control of Publicly Traded Firms Around the World, 1996 (%) (of the 20 largest firms under each Category)

Economy	Widely Held	Family Owned	State Owned
Australia	65	5	5
Austria	5	15	70
Belgium	5	50	5
Canada	60	25	
Denmark	40	35	15
Finland	35	10	35
France	60	20	15
Germany	50	10	25
Greece	10	50	30
Ireland	65	10	
Italy	20	15	40
Japan	90	5	5
Netherlands	30	20	5
New Zealand	30	25	25
Norway	25	25	35
Portugal	10	45	25
Spain	35	15	30
Sweden	25	45	10
Switzerland	60	3	
UK	100		
USA	80	20	

Source:

Iskander, M., & Chamlou, N. (2000). *Corporate Governance : A Framework for Implementation*. Washington, D.C.: World Bank

Appendix 21: Duties of Directors in the 2006 CBK Guidelines

- 1) Regulating the manner in which the business is conducted.
- 2) Corporate planning
- 3) Establish and ensure the effective functioning of Board and Management Committees in key areas
- 4) Set-up an effective internal audit department of management audit.
- 5) Set-up an independent Compliance Function
- 6) Maintain adequate capital base
- 7) Observe Laws and guidelines
- 8) Appoint, dismiss and define the duties of management
- 9) Be informed about business condition of the institution
- 10) Attend Board meetings regularly
- 11) Maintain Positive Image

Source:

Central Bank of Kenya (2006) Prudential Guidelines 2006. Nairobi: Central Bank of Kenya pp., 30-32